AN EXAMINATION OF BANK EXPANSION BY DIRECT MERGER AND THE HOLDING COMPANY ROUTE IN VIRGINIA, 1962-1966

by

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Abstract of

AN EXAMINATION OF BANK EXPANSION BY DIRECT MERGER AND THE HOLDING COMPANY ROUTE IN VIRGINIA--1962-1966

This study examines the management considerations involved in selecting between direct merger and the holding company as an organization for commercial bank expansion. The setting of the study is Virginia; the period 1962-1966, when a "revolution" in the state banking structure began.

The focus of this study is on two banks--First and Merchants National Bank of Richmond, which expanded by direct merger; and United Virginia Bankshares of Richmond, which expanded by the holding company route. Their expansion experiences were investigated to determine, in so far as possible from the management point-of-view, the advantages and disadvantages of each form of organization. The objective of this study was to develop information which might be useful to managements when choosing between the two forms, and to legislators in states where changes to unit or limited branching statutes could result in expansion by both direct merger and holding company.

The examination of the experiences of the two organizations points to the fact that the choice of a particular method of expansion turns on considerations which are largely particular to a given situation. Therefore, there seem to be no "right" or "wrong" answers in the normative sense. However, there are certain considerations--operational and organizational, financial, marketing and legal--which can be important in the selection of a form of expansion. When these considerations are measured against an explicit set of criteria, the strength of the holding company in Virginia is greater profit and growth potential due to more extensive <u>de novo</u> branching opportunities, lower reserve ratios applied against total system deposits, and greater flexibility in raising capital and use of debt. By the way of contrast, the strength of the merged form in Virginia is the possibility of tighter management control and the potential for greater organizational efficiency.

Regarding the ability of both forms to adapt in the future to environmental and technical change, the conclusion is that the merged form--given equal legislative opportunities for growth and profit--probably will become the more viable form of banking in Virginia. This is because the merged form appears to be best suited to respond to change over the long run.

TABLE OF CONTENTS

CHAPTER I

INTRODUCTION

This study deals with the mechanism of commercial bank expansion. The setting is Virginia; the period is 1962-1966, when a "revolution" in the banking structure of the State began. The primary focus is on two prominent banking organizations in Virginia: First and Merchants National Bank and United Virginia Bankshares, both of Richmond.

In 1962, the state banking code was changed to permit statewide branching by merger. This dissertation examines the management decisions which resulted in First and Merchants National Bank choosing to expand by direct merger and United Virginia Bankshares choosing to expand by the holding company route.

The purpose, scope and limitations of this research are described in Chapter II. This includes a discussion of the various phases of the research plan: (1) data collection, (2) selection of the organizations studied, (3) timing of the study, and (4) data analysis.

Chapter III presents historical background concerning important events influencing the structure of banking in Virginia and Chapter IV describes significant changes that tock place in the Virginia banking structure, during the 1962-1966

period of expansion. Together, these chapters are intended to provide an historical perspective of important environmental factors that influenced Virginia bankers and legislators in their deliberations regarding the appropriate type of banking structure for the state.

Chapter V reviews the literature concerned with advantages and disadvantages of expansion by way of direct merger and the holding company route. This chapter provides a departure point for subsequent examination of the factors considered by First and Merchants National Bank and United Virginia Bankshares in their selection of a method of expansion.

The findings, analysis and conclusions of this study are presented in the last five chapters. The findings are primarily based on an examination of the expansion experiences of the organizations studied. Chapter VI addresses itself to the background events concerning the decision of First and Merchants National Bank and United Virginia Bankshares to choose a method of expansion. Chapter VII deals with operational and organizational considerations which were thought to be significant by both managements; Chapter VIII with the financial considerations; Chapter IX with the marketing considerations; and Chapter X with the legal considerations. Chapter XI draws together and relates in summary form the important findings and conclusions from the previous chapters.

Eight appendicies are included at the end of the dissertation. These appendicies contain: (1) excerpts from the Virginia legislation regulating branching, (2) transcripts of the field research, and (3) statistical and other relevant information.

CHAPTER II

PURPOSE AND RESEARCH PLAN

With enactment in 1962 of liberalized branching legislation, Virginia became a state where bank management could choose either direct merger, the holding company or a combination of the two, as a method of expansion. For this reason, legislative conditions in Virginia provide a unique opportunity to study the circumstances involved in selecting a method of bank expansion.

Two banking systems in Virginia--First and Merchants National Bank and United Virginia Bankshares--were chosen for this study. Management in each organization was presumed to have been influenced by similar legislative and economic conditions, and to have considered basically the same factors in deciding on a form of organization for expansion. Nevertheless, the managements of these two organizations made different decisions. In as much as each sought to achieve the same general goal of statewide expansion, the following research question provides the focus to this study:

> "What were the central issues considered by the managements in their decisions to expand by the way of direct merger or the holding company route? Or, in other words, how were these issues assessed by the managements in terms of the advantages and disadvantages of one form of organization relative to the other?"

PURPOSE OF THE STUDY

The principal objective of this study is to examine: (1) the advantages and disadvantages of direct merger and the holding company as drawn from the literature, (2) the direct merger experiences of First and Merchants National Bank, and (3) the holding company experiences of United Virginia Bankshares, with a view toward evaluating these areas as guides for management action. Where an apparent conflict existed between the literature and management or between the two managements, then the objective shifts to an attempt to determine if this conflict provided a basis for an improved understanding of, or insights into, the issues involved in the selection of a method of expansion.

Banking history in Virginia was discussed with a view toward identifying significant forces and events that influenced the banking structure of the state. Bankers' attitudes toward branching and consumer credit, and the legislation regulating bank expansion were among the more important considerations examined.

The literature was examined with the aim of identifying the advantages and disadvantages of expansion by direct merger as opposed to the holding company route. Information thus derived provided a part of a theoretical construct which was subsequently applied to actuality, i.e., it was used to examine

the management decisions of the two banks studied. This examination, however, was not intended to judge whether management's actions were "right" or "wrong" in the normative sense, but to determine where differences, if any, existed between the advantages and disadvantages ascribed to the two forms in the literature and those considered by management.

Significance

An underlying hypothesis of this study is that some of the advantages and disadvantages of the two forms, alleged in the literature, actually do not apply in practice. In this context, the individual circumstances of each organization seemingly account for the differences between the literature and actuality. If this hypothesis proved to be correct, then apparently the examination of the experiences of the organizations studied might result in information which may be useful to other managements in choosing between the two forms of expansion.

Similarly, the findings here may be relevant to legislators in other states where changes to unit or limited branching statutes could result in expansion by both direct merger and holding company. In 1966, there were 33 states in this category including Ohio, Texas, Illinois, and Wisconsin.[1]

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[1]In 1966 the 33 states with unit and limited branching statutes accounted for 88 percent of the 13,785 banks and 79 percent of the $410 billion of total deposits in the United States.

II. SCOPE AND RESEARCH PLAN

Scope

The study embodies four general areas. The first is the historical background of bank expansion in Virginia during the period 1920 to 1966. This includes identification of various economic and political factors leading to passage of legislation in 1928, 1948 and 1962, which regulated the expansion of banks by merger and branching. These factors were examined in terms of their impact on the development of multiple office banking in Virginia.

The second area is the Virginia banking structure. This involves an examination of the evolution of the structure between 1962-1966, focusing on those changes resulting from the growth of statewide banking systems.

The third area is the literature. There the advantages and disadvantages of direct merger and the holding company were developed as a frame of reference, or point-of-departure, for evaluating the expansion experiences of the two organizations studied.

The fourth and last area is the expansion experiences of First and Merchants National Bank, a merged system, and United Virginia Bankshares, a holding company. The focus of this area is on the central issues considered by the managements in their selection of the most appropriate form of expansion and on the significant factors in their expansion strategies.

Research Plan

There were five aspects of the research plan: (1) data collection, (2) selection of the organizations studied, (3) point-of-view, (4) timing, and (5) analysis.

Data Collection. Material for this study was gathered in three phases. The first was directed at obtaining historical information and background regarding the expansion of banks in Virginia. The second dealt with an examination of the literature in order to develop a frame of reference, or point-of-departure, for investigation of the research question. The third, and most important phase, involved field research in order to obtain material on the two organizations studied. Here management's decision to expand and the expansion experiences of the two banking organizations were investigated.

Selection of the Systems Studied. From among the six major Virginia banking organizations involved in statewide expansion during the period 1962-1966, two were selected for study: First and Merchants National Bank, a merged system and United Virginia Bankshares, a holding company.[2] The

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[2] The major systems involved in statewide expansion during the period 1962 to 1966 were:

By Merger

1. First and Merchants National Bank of Richmond
2. Virginia National Bank of Norfolk

By Holding Company

selection of these two organizations provided a basis for sharpening the issues being investigated:

A. Among the four holding companies that could have been used, United Virginia Bankshares [hereafter referred to as Bankshares] had the clearest option to select either method of expansion. Bankshares had not filed with the Securities Exchange Commission to form its holding company prior to the introduction of legislation, in January 1962, which authorized expansion by direct merger.[3] By way of contrast, First Virginia and Financial General, both holding companies, were in operation in Virginia <u>before</u> the 1962 legislation. Consequently, they were already committed to a particular method of expansion. The remaining organization, Virginia Commonwealth, had already decided to form a holding company before the January 10, 1962 opening of the General Assembly.[4] Liberalized branching legislation was introduced in the General Assembly on January 18, 1962 and became effective July 1, 1962.

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1. Financial General Corporation of Washington, D. C.
2. First Virginia Bankshares Corporation of Arlington
3. United Virginia Bankshares, Incorporated of Richmond
4. Virginia Commonwealth Bankshares Corporation of Richmond

NOTE: First National Exchange Bank of Roanoke is not included because it served only the southwestern region of the state. With Metropolitan National Bank of Richmond it formed a new holding company in 1967--Dominion Bankshares Corporation.

[3] Cf. Appendix (A), p. A-3.

[4] Cf. Appendix (B), p. B-14, n. 7.

B. First and Merchants National Bank [hereafter called First and Merchants], like Bankshares, also had the opportunity to select either method of expansion. It had not made a final decision on a method of expansion prior to enactment of the 1962 legislation.[5]

C. In addition to the fact that Bankshares and First and Merchants were free to choose either form of expansion, both organizations made their decisions to expand during approximately the same period of time. Consequently, their decisions were made under similar external environmental conditions. Furthermore, both organizations were alike with regard to location, size, and expansion strategy; both were large Richmond organizations with extensive correspondent systems; both had worked actively for the liberalization of branching legislation in 1962.

By way of contrast, Virginia National Bank of Norfolk, the second major merged system, did not offer as valid a comparison to Bankshares, as did First and Merchants. Its location and expansion strategy were different from that of Bankshares in that Virginia National--home office in Norfolk--had expanded into both rural and metropolitan areas of the state,

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[5] Cf. Appendix (C), p. C-3.

whereas Bankshares--home office in Richmond--had concentrated on the metropolitan areas.[6]

<u>Point-of-View</u>. The <u>field</u> research was conducted from the management point-of-view. It focused on the management decision-making problem of selecting either direct merger or the holding company as a method of expansion.

<u>Timing</u>. It was clearly advantageous to conduct this study while the top managements responsible for planning and executing the expansion decisions were still active in their organizations. Conducting the study only five years after the decision was made, and while expansion was still an active program, served to examine the important issues when they were still relatively current in time. Clearly, any substantial delay in conducting the field research would have reduced the accuracy and comprehensiveness of the information collected.

With regard to the changes taking place in the Virginia banking structure it was thought--for two reasons--that the period 1962-1966 was sufficiently long to reflect many of the underlying trends. First, the wave of mergers and holding company acquisitions was not likely to continue for an extended length of time since the supply of acquisition eligible

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[6] Interview with Mr. R. Cosby Moore, Chairman of the Board, Virginia National Bank on July 31, 1967.

banks was being reduced. Second, as the merger and holding company movement matured, banks expanding on a statewide basis were likely to approach the geographic limits of their expansion plans.

Analysis. The analysis was designed to use the material drawn from the literature as a frame of reference, or point-of-departure, for the evaluation of the expansion experiences of the organizations studied. First, similarities and differences were explored between the literature and the point-of-view of the two managements in their selection of a form of organization for expansion. Next, the expansion strategy and results of expansion were examined to investigate further the relevancy of the information drawn from the literature. In this manner, the structure of the analysis tested the consistency between these positions with a view toward evaluating the relative merits of expansion by direct merger and holding company.

Quantitative data such as deposits, earnings and selected operating results were used for two purposes. First, this information was used to describe the results of expansion and, second, as evidence in examination of certain of the alleged advantages and disadvantages of the alternative methods of expansion.

III. LIMITATIONS

This research has several major limitations. First, the study did not encompass all of the major statewide banking systems in Virginia. Second, the focus of the field research was limited to a single point-of-view--that of management. Consequently, the scope of the field research did not investigate management considerations or actions in the context of standards of "public welfare" or "public benefit", except in so far as management considered them. However, this limitation of scope did not apply to the analysis of management's expansion experiences. Here, for instance, the points-of-view of other interested parties--such as stockholders or customers--were considered.

A third limitation was that the findings and conclusions may require modification as the passage of time provides more experience. For example, the advantages and disadvantages of one form of banking organization may change as the result of future state or national legislation, or after the merger and holding company movement in Virginia has slowed down.

A fourth limitation of this research concerned the use of quantitative data primarily for descriptive purposes. The study did not include in-depth analysis supporting or contradicting previous research findings in areas such as: (1) economies of scale, (2) performance to structure relationships, or (3) concentration to competition relationships.

CHAPTER III

HISTORICAL BACKGROUND

A controversy underlying changes to state legislation regulating expansion has involved the "unit" versus "branch" banking issue.

> "Probably there is no older or deeper banking controversy than that between the proponents of unit banking, who believe such a system is essential to the maintenance of competition and the preservation of small banks, and the proponents of branch banks, who insist that efficiency and stability require multi-office institutions."[1]

The purpose of this chapter, however, is not to judge the relative merits of "unit" versus "branch" banking *per se*, and the diversity of state legislation which reflects the many attitudes on this issue. But, rather, the purpose is to develop an historical perspective of the environmental factors and forces that influenced Virginia bankers in their deliberations concerning the appropriate banking structure for the state.

The discussion is divided into six parts: (1) the 1922-1928 period, (2) the 1928 legislation, (3) the 1929-1948 period, (4) the 1948 legislation, (5) the 1949-1962 period, and (6)

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[1] Commission on Money and Credit. *Private Financial Institutions*, Englewood Cliffs, N. J.: Prentice Hall, Inc., 1963, p. 47.

the 1962 legislation. The developments of the 1962-1966 period of expansion are dealt with separately in Chapter IV.

I. THE 1922-1928 PERIOD

The events of 1922-1928 culminated in the passage of restrictive branching legislation in 1928. Three salient features stood out in this period. First, state chartered banks in Virginia could establish de novo branches in areas throughout the state.[2] On the other hand, National banks were prohibited from branching under previous interpretations of the National Bank Act of 1864.[3]

The second and third salient features centered on the situation of The Morris Plan Bank of Richmond, now The Bank of Virginia. This was the only bank in the state which had established de novo branches in large cities other than its home office in Richmond. Furthermore, this bank operated under a Morris Plan franchise. The fact that it did not operate as a regular commercial bank and that it established

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[2] De novo refers to expansion by the opening of new branches.

[3] Gerald C. Fischer, American Banking Structure (New York: Columbia University Press, 1968). See Chapter II for a historical discussion of the development of unit and branch banking, including legislative aspects. National Banks were not permitted to branch under Federal law until passage of the McFadden Act in 1927. This law limited branches of national or state member banks to their home city.

branches may have deterred other banks from branching on an area wide basis.

The Role and Influence of The Morris Plan Bank of Richmond

The Morris Plan Bank of Richmond had been founded in 1922 by Thomas C. Boushall, formerly an officer of the then National City Bank of New York.[4] Interested in starting a Morris Plan Bank in Richmond, Boushall received a franchise and financial backing from Arthur J. Morris, who was expanding the plan throughout the country.[5]

The Morris Plan Bank of Richmond was unusual in that it had a regular commercial bank charter, even though it operated a Morris Plan franchise; it did not, however, take demand

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[4]Cf. Appendix (B). Background on The Bank of Virginia was obtained through interviews with Mr. Thomas C. Boushall, Honorary Chairman of the Board and founder of The Bank of Virginia, and Mr. Frederick Deane, Jr., current President of The Bank of Virginia. The bank has had only two chief executive officers since its founding in 1922. The current chief executive is Mr. Herbert Moseley, who succeeded Mr. Boushall in 1959.

[5]Ibid., p. B-2. A Morris Plan Bank was a financial institution which accepted as deposits only savings accounts and which made only instalment loans to individuals. This system of Morris Plan lending was devised by Arthur J. Morris, who is still a director of The Bank of Virginia. In 1910 when Mr. Morris opened the first Morris Plan Bank in Norfolk, the availability of credit to average wage earning individuals was almost nonexistent. The original approach to the Morris Plan Bank was designed to fill the need for credit facilities for wage earners throughout the United States who, generally speaking, were not receiving this service from commercial banks of the day.

deposits or provide other commercial services. Activities were limited to savings accounts and instalment loans to individuals and small businesses. Late in 1922, the bank opened a branch in Petersburg. In 1925 another branch was opened in Newport News, by merger with the Merchants and Mechanics Savings Association. In 1928, a third branch was opened in Roanoke. Also, that same year, merger of The Morris Plan Bank of Norfolk made that bank a branch of The Morris Plan Bank of Richmond.[6]

Reaction of Virginia's Commercial Bankers to The Morris Plan Bank of Richmond. The branching activities of The Morris Plan Bank of Richmond and its business in consumer instalment loans were not in consonance with the tradition of commercial bankers in Virginia.[7] These deviations from tradition were such an unusual step away from the norm that The Morris Plan Bank of Richmond was said to be an anathema to many bankers in the State.[8]

Virginia commercial bankers' attitudes were described as being "steeped in tradition", and this description helps

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[6] Ibid., p. B-3. The Morris Plan Bank of Norfolk was the original Morris Plan Bank founded by Arthur J. Morris in 1910 under the name of Fidelity Loan and Trust Company.

[7] Ibid., pp. B-3-5.

[8] Ibid.

to explain why only one bank in Virginia was branching on an area wide basis during the 1920's. For instance, typical comments of commercial bankers to the chief officer of The Morris Plan Bank of Richmond were that it was poor banking practice and an unnecessary risk to have "someone else lend your money" in branches distant from Richmond; that consumer lending was a dangerous practice since it was not a reliable or desirable business, and; that the consumer loan would likely have an unacceptably high default rate.[9] This lack of enthusiasm for branching on the part of Virginia bankers, however, was typical of the general attitude of commercial bankers elsewhere. In 1922, the American Bankers Association, in apparent response to various proposals to permit branching by national banks, adopted a resolution which stated:

> "We regard branch banking or the establishment of additional offices by banks as detrimental to the best interest of the people of the United States. Branch banking is contrary to public policy, violates the basic principles of our government and concentrates the credits of the Nation and the power of money in the hands of a few."[10]

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[9] Ibid. On the question of "someone else lending your money", Boushall said that bankers failed to recognize a branch was not "someone else", but it was an extension of the main bank.

[10] Fischer, American Banking Structure, op.cit., p. 45.

And it was not until 1930 that the American Bankers Association modified its position on branching.[11]

The geographic and economic character of the state also serves to explain why only one bank in Virginia was branching in the 1920's. Virginia was divided into distinct regions: (1) Tidewater Virginia--Norfolk, Newport News, Portsmouth--was maritime oriented, (2) Richmond was tobacco oriented, and (3) Northern Virginia was closely associated with the Federal Government. Furthermore, some areas in Virginia had closer association with neighboring states, and in some cases still do today: (1) Bristol in the far southwestern corner of the State had closer ties with Tennessee, and (2) the isolated Eastern Shore had closer ties with Maryland. Because these separate areas of Virginia had few economic, political or social ties, branching across geographic boundaries was unattractive to commercial bankers. However, to The Morris Plan Bank of Richmond branching was an essential element of strategy. Management in this bank believed that it was necessary to serve the major population centers, where the majority of the consumers were located.[12] In contrast to this, the lack of interest in branching on the part of commercial bankers in Virginia suggests that they were content to maintain the status

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[11] Ibid., p. 49.

[12] Cf. Appendix (B), p. B-5.

quo, to continue to serve commercial customers within their individual marketing areas.

Developing Response of Virginia's Commercial Bankers to The Morris Plan Bank of Richmond. "Friction" was developing between The Morris Plan Bank of Richmond and some of the other commercial banks in Virginia. This situation came into the open early in 1928 when the Virginia Bankers Association prepared a revision to the existing banking code, to be submitted to the Virginia General Assembly. This revision was to restrict the authority of banks to branch or merge outside of the home area of the parent bank, and to limit to 4 percent per annum the maximum amount of interest a bank could pay on savings deposits. The Morris Plan Bank of Richmond, a member of the Association, had not been advised of this proposal during the time it was being prepared by the Virginia Bankers Association.

Actually, the revision was contrary to many of the basic policies of this bank and, in fact, appeared to be specifically aimed at restricting its activities.[13] For instance, The Morris Plan Bank of Richmond had paid 5 percent interest since

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[13] Thomas C. Boushall, "A Statement on Behalf of The Bank of Virginia," to the Special Committee Appointed by the President of The Virginia Bankers Association to Study the Current Branch Banking Statutes as well as suggestions for their revision, April 24, 1948.

its founding in 1922. The 5 percent savings rate was seen by the commercial banks as a threat to drain away their savings deposits, since their rates were generally 3 percent in the Richmond area and 4 percent elsewhere.[14] For this reason, it appeared that the 4 percent rate limitation was a move to restrict competition from The Morris Plan Bank of Richmond for saving accounts by bringing its rate in line with that paid by the commercial banks.[15]

This effort of the Virginia Bankers Association to limit branching and saving deposit interest was also related to legislative developments on the national scene. In the period 1910-1930 a great number of states passed legislation prohibiting branch banking or restricting the location of branches to limited areas. In 1910 there were 8 states with legislation prohibiting branching, but by 1930 the number had reached 23,

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[14]Cf. Appendix (B), p. B-6.

[15]The difference in viewpoints between The Morris Plan Bank of Richmond and the commercial bankers in Virginia is forcibly demonstrated by the Virginia Bankers Association proposed new statute to restrict further expansion of that bank and to render less effective its competition for savings accounts by setting a ceiling on savings interest. This action suggests commercial banks generally were not concerned with the "public welfare" and that they had no evolving "concept" or "scheme" of what the commercial banking industry should be--it appears to work against the "public welfare" since it was aimed at reducing interest paid on savings and constraining the growth of a new developing segment of banking which was intended to provide a source of credit to the consumer.

its historical high.[16] Two three-year periods, 1921-1923 and 1927-1929, account for approximately one-half of the antibranching legislation enacted by the states between 1910-1930.[17] This concentration of antibranching legislation in these periods was attributed to activity of the Comptroller of the Currency and national banks to permit national bank branching. In the 1921-1923 period:

> "... Comptroller of the Currency Crissinger requested that Congress pass a limited branch bill for national banks, and when this was not done he began to authorize some of the institutions under his jurisdiction to establish limited service branches in their head-office cities. The impetus these and other actions gave to the antibranch movement in the early 1920's was quite apparent by 1923 in the trial of the St. Louis case. This was the first clear test of the branching power of national banks, and the opponents of branching were so effective in convincing their state officials of the importance of this litigation that eleven state attorneys general filed briefs as <u>amici curiae</u>, supporting the position of those opposed to national bank branching."[18]

The action by the Virginia Bankers Association to restrict branching, in 1928, came at the peak of antibranching sentiment at the national level. This sentiment again had

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[16] Fischer, <u>American Banking Structure</u>, <u>op.cit</u>., p. 59.

[17] <u>Ibid</u>., p. 61.

[18] <u>Ibid</u>., pp. 62-63.

resulted from an effort on the part of national banks to obtain equal branching privileges with state banks:

> "The second interval in which a large number of states prohibited branch banking began with passage of the McFadden Act in 1927 and terminated in 1929. In the 1927 legislation the antibranch forces had won a considerable but not complete victory. Branching by national banks was limited to the head-office city (town, village) and it was allowed only if the relevant state law also permitted state banks to establish and operate branches."[19]

Consequently, it is reasonable to assume that the passage of the McFadden Act influenced the Virginia legislation; this supposition is supported by the fact that provisions of the McFadden Act were reflected in the amendment to the statutes proposed by the Virginia Bankers Association. Moreover, the announced expansion plans of The Morris Plan Bank of Richmond to branch into new areas gave specific meaning to the legislation in Virginia.

However, during the 1928 session of the General Assembly, the Chairman of the Legislative Committee and the Secretary of the Virginia Bankers Association called on the President of The Morris Plan Bank of Richmond. In this meeting it was suggested that if the bank's representatives would support the proposed code change limiting savings interest to 4 percent, the Legislative Committee of the Association would

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[19] Ibid. pp. 63-64.

undertake to have the code amended specifically to permit branches in other cities than that of a bank's head office, provided the cities would have a minimum population of 50,000.[20] This compromise was accepted by The Morris Plan Bank; it was subsequently incorporated into the 1928 banking code, which established legislative framework for "limited branching" in Virginia.[21]

II. THE 1928 LEGISLATION

The legislation approved in 1928 was more restrictive of branching activities than the previous legislation.[22] Specifically it restricted expansion by *de novo* branches, merger, or purchase to limited geographic areas. The State

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[20] Cf. Appendix (B), pp. B-5-6.

[21] *Ibid.*, p. B-6. An ironic twist to this power play by the commercial banks was that The Morris Plan Bank of Richmond wanted to reduce its 5 percent savings rate, yet could not for fear of losing depositors. It so happened that the bank was having a difficult time attracting savings even though 5 percent was paid and most commercial banks paid 3 to 4 percent. A large segment of the saving public shared the feeling that "something must be wrong" if the prestigious commercial banks are paying only 3 to 4 percent and this new bank 5 percent. The Morris Plan Bank of Richmond was looking for a way to solve the "5 percent rate problem" and, at the same time, continue to expand in the more populated areas of the state; therefore, the compromise of rate reduction for limited branching was readily accepted.

[22] As was noted earlier, bankers in many places in the country in the 1920's and 1930's, not just Virginia, were able to affect the course of legislation and thus influence the course of competition in their states.

Corporation Commission was permitted to authorize banks having paid-up and unimpaired capital and surplus of $50,000 or more to branch:[23]

a) within the limits of the city, town or village in which the parent bank was located.

b) in any city having a population of not less than fifty thousand inhabitants; and

to merge or purchase a bank:

a) within the same or adjoining counties or banks within a distance of twenty-five miles of a parent bank, provided that the banks involved had been in actual operation for a period of two years or more, except that the State Corporation Commission under certain conditions could waive this time requirement.

The effect of this legislation was to restrict bank expansion to the geographic area immediately surrounding the home office and to population centers of 50,000 and more. Newport News, Norfolk, Petersburg, Portsmouth, Richmond, and Roanoke met the population criteria for de novo branches in the period 1929-1948.

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[23] Cf. Appendix (D), Branching Provision of the 1928 Legislation (Excerpts from the Code of Virginia 1942, Chapter 164A).

III. THE 1929-1948 PERIOD

During the years 1929-1948, commercial banks began to expand into the area of consumer finance and, in turn, The Morris Plan Bank of Virginia into commercial accounts.[24] Therefore, "head to head" competition in addition to branching were issues which contributed to the enactment of even more restrictive branching legislation in 1948.

The Early Image of The Morris Plan Bank of Virginia

During the years 1920-1940 commercial bankers considered The Morris Plan Bank of Virginia, operating in the instalment loan area, nothing more than a high-class small loan company.[25] This attitude was aggravated by the fact that historically commercial bankers had not considered it ethical to advertise for loans--and this continued into the 1930's--whereas Morris Plan banks engaged in extensive advertising. They were characterized as "sort of razzle-dazzle promoters from the beginning," i.e., merchandise was given away to get accounts.[26]

While such practices are acceptable today, the Morris Plan banks were doing this at a time when it was considered

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[24] Name changed from The Morris Plan Bank of Richmond to The Morris Plan Bank of Virginia, July 1, 1928.

[25] Cf. Appendix (B), p. B-7.

[26] *Ibid.*, p. B-7.

most improper.[27] These circumstances reinforced the view of the commercial bankers in Virginia that the small Morris Plan Bank of Richmond was not really a bank at all, and certainly not of the same stature as a commercial bank.[28]

Commercial Banks--Consumer Finance

During the years 1920-1939 and on through World War II, the volume of commercial bank loans strongly tended downward. In the decade of the 1920's total commercial loans of all national banks decreased from just over 10 billion dollars to approximately 7.5 billion dollars.[29] This decrease was attributed to a general "role back" of commercial borrowing from banks:

> "Business, influenced among other factors by the cheapness and abundance of long term funds, turned more and more in this period to the securities markets for its capital requirements, and relied less and less upon the banking structure, so that commercial loans declined as bond--and stock--prices increased."[30]

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[27] Ibid. There were no other Morris Plan banks in Virginia after the conversion of The Morris Plan Bank of Portsmouth into the Commercial Exchange Bank around 1940.

[28] Ibid.

[29] Albert R. Koch, The Financing Of Large Corporations 1920-1939 (New York: National Bureau of Economic Research, 1943), p. 69.

[30] Charles Cortez Abbott, The New York Bond Market 1920-1939 (Cambridge, Massachusetts: Harvard University Press, 1937), p. 153.

By the end of the 1930's the total of commercial loans of all national banks was down to just over 4 billion dollars, a decrease of approximately 6 billion dollars since 1920.[31] The depression in the 1930's accounted for this continuing downward trend. And this trend continued through World War II--corporations were highly liquid from war contracting profits; the non-essential segments of the business sector found it difficult to replace depleted inventories; capital outlays were generally limited to war industries, for war essential new capacity. Consequently, commercial bank loans were further liquidated and banks shifted heavily into the government securities market, where the government was deficit financing the war effort.

Therefore, during the whole period from 1920-1945, there was every reason for commercial banks to look for new outlets for loans. However, most commercial bankers were slow in recognizing and responding to the opportunities in the area of consumer finance. As a result of this, the large-scale entry of banks into the field of *direct* consumer lending is a comparatively recent development in the history of commercial banking.

There Was a Slow Shift in the Attitude of Commercial Bankers Toward Consumer Credit in the Late 1920's and 1930's.

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[31] Koch, *op.cit*.

Prior to the 1900's direct consumer lending by commercial banks was conducted on a highly selective basis. Most banks were engaged in the occasional extension of direct consumer loans, but the practice was most generally confined to the accommodation of established bank customers; as a general rule, it was looked upon as an exception to established bank lending policy. The shift in bank attitudes came slowly and not uniformly among individual banks, and by the end of the 1920's a number of large banks in the nation had established personal loan departments.

> "The National City Bank of New York was the first major commercial bank in the United States to establish a separate department for making small loans, when it inaugurated its Personal Loan Department on May 4, 1928. The general pattern of its initial program was modeled on the Morris Plan, which was inaugurated by Arthur J. Morris as early as 1910 in Norfolk, Virginia. Our bank, however, developed its own forms and internal procedures. Its general objective was to provide loans in modest amounts at reasonable rates, repayable in monthly instalments to wage earners, small merchants and others who, at that time, had little or no credit standing in commercial banks. The extension of such credit facilities was a logical outlet for deposits resulting from savings accounts, another service which commercial banks adopted in the twenties."[32]

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[32] First National City Bank of New York, letter dated September 27, 1968.

In the 1930's, growth in demand for consumer credit associated with the mass appeal of the automobile, favorable experience of banks in consumer lending under programs of government loan insurance, the combination of low interest rates, large excess reserves and recognition of amortization principles to consumer goods, served to stimulate bank interest in consumer lending.[33]

Also, the economic impact of the depression altered attitudes toward consumer credit. Commercial banks were not making many loans because the national economy was stagnant and commercial customers were reluctant to borrow. At the same time, the depression affected consumer lending, but not quite to the same extent. Therefore, there was relatively more demand for consumer credit than commercial credit.[34]

Virginia Commercial Banks--Consumer Finance

In Virginia, The American Bank and Trust Company of Richmond opened a consumer loan department in 1927.[35] This was said to have had a startling impact on the banking

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[33] Commission on Money and Credit, op.cit., pp. 162-64.

[34] Cf. Appendix (B), p. B-8.

[35] Ibid., n. 3. Also it was noted that The National City Bank of New York (now the First National City Bank) visited The Morris Plan Bank of Virginia to study the procedures and forms prior to establishment of its own consumer instalment loan operations in 1928.

community in the state and elsewhere.[36] Yet, two points suggest a continuing lack of interest in the consumer area by this bank and by other commercial banks in Virginia. First, American Bank and Trust located its consumer loan department in the basement of its building, probably to separate its "working man" business from its "carriage trade."[37] And, five years later when the bank did not reopen after the bank holiday, "paper" from its consumer loan department offered to The Morris Plan Bank of Virginia totaled approximately $116,000. This amount was negligible when compared to The Morris Plan Bank of Virginia's $7 1/2 million.[38] Second, The Morris Plan Bank of Virginia, in 1937, held more consumer instalment loans than all of Virginia's commercial banks and finance companies combined.[39]

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[36] Ibid., p. B-8.

[37] Interview with Mr. A. Halsey Cook, Executive Vice President, First National City Bank of New York, on October 3, 1968. The supposition that the basement location was to separate the "working man" and "carriage trade" is supported by the fact that the First National City Bank of New York--when establishing its consumer loan department--also chose to operate this department apart from its commercial business for this reason.

[38] Appendix (B), B-9.

[39] Ibid. Another example of a commercial bank's attitude toward consumer credit was the effort on the part of a New York correspondent bank to drop The Morris Plan Bank of Virginia's $300,000 line of credit unless auto loans and new office construction were stopped. In 1928 the Morris Plan Bank of Virginia was the first bank in the state to buy dealer automobile paper and in 1935 the first to do extensive direct (over-the-counter) collateral auto loans to consumers.

An article on banking in Virginia, published in 1965, termed the expansion of commercial banks into consumer credit "the revolution of service". It confirms the "tradition bound" attitude of Virginia's commercial bankers, which has been described in the earlier paragraphs:

> "The commercial bank of today is indeed the department store of finance--but it has not always been so. Throughout the 19th Century and in the early years of the 20th Century, Virginia bankers, along with their fraternity brothers in other parts of the nation, were steeped in the banking principle of note and deposit issue based upon short-term, self-liquidating business credit. True, some loans were made to individuals, for home purchase or for other reasons, but the credit rating had to be of the highest quality. In the early 1920's, Virginia bankers still considered the active promotion of banking services for the average individual as outside the area of active competitive pursuit. However, a change was already under way which, although more than two decades were to pass before its fruition, was destined to change the patterns of accepted banking practices more drastically than any previous change in banking's history. This emerging change acknowledged the fact that commercial banking had much to offer to the average individual and that the individual, in large numbers, could make a substantial contribution to bank profits.[40]

<u>The Morris Plan Bank of Virginia Becomes a Full Service Bank</u>

In the 1930's, policy changes were initiated at The Morris Plan Bank of Virginia to broaden the scope of its

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[40] R. Pierce Lumpkin, "Virginia Banking Today: The Quiet Revolution," <u>The Commonwealth</u>, March 1965, p. 27.

services. These changes were in response to the entry of commercial banks into the area of consumer credit.[41] Initially, The Morris Plan Bank of Virginia took only checking accounts of individuals. Later commercial checking accounts were taken and just before World War II, the bank entered the commercial lending field in active competition with the other commercial banks.[42] However, The Bank of Virginia's commercial growth and development phase did not really start until after World War II.[43] Before that time the bank had commercial accounts, but in a modest amount.

The Branching Issue Arises Again

By 1948 The Bank of Virginia had successfully implemented its strategy of expanding into the commercial area in direct competition with commercial banks. It had grown to be the sixth largest bank in Virginia.[44] It was still the only bank in the State which had developed a branch system in cities with a population over 50,000, and it had plans to expand into

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[41]Cf. Appendix (B), p. B-9, n. 5. Boushall noted that government insured FHA Home Improvement Loans in 1934 were a factor which brought Virginia's commercial banks into the consumer area.

[42]*Ibid.*, p. B-9-10.

[43]*Ibid.*, p. B-10. The bank's name was changed from The Morris Plan Bank of Virginia to The Bank of Virginia, January 1, 1946 in order to qualify more specifically for commercial accounts.

[44]Cf. Appendix (E), Table E-I.

new areas when they met the population provisions of the branching laws.[45] Thus, the move of The Bank of Virginia into commercial accounts, the anticipated expansion of the bank into Alexandria and the request for approval of a third branch in Norfolk were circumstances which rekindled the branching issue among some of the commercial bankers in the state.[46]

Another matter of concern to some of the bankers in Virginia was the question of "out-of-state control." Since its founding the major stockholder in The Bank of Virginia had been the holding company established to franchise Morris Plan banks throughout the United States. As late as 1953, when the control of The Bank of Virginia was sold, the holding company still owned 57 percent. This out-of-state ownership compounded the unfriendly feeling of the other commercial banks in Virginia towards The Bank of Virginia; it was used by the opponents of branching to argue the "alleged dangers" of out-of-state control.[47] So for the second time in 20 years

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[45]Cf. Appendix (B), p. B-10. The Bank of Virginia expected that Alexandria would meet the 50,000 population requirement after the 1950 Census.

[46]Ibid., pp. B-10-11. Dean stated that The Bank of Virginia had grown up "relatively unnoticed" by the other commercial bankers because it was not until after World War II that it became an active and aggressive competitor in the commercial accounts area and because it had not been considered a legitimate competitor up to that time.

[47]Ibid., pp. B-11-12.

The Bank of Virginia, as a major proponent for expansion, was about to play a central role in a controversy over legislation to curb branching.

Press Coverage of the Branching Issue

In February 1948 an editorial reported the issues being discussed in the following terms:

> "It is regrettable that the question of the advisability of placing stricter limits on branch banking in Virginia has been raised in a way that makes it difficult for the General Assembly to decide the issue strictly on its merits and from the standpoint of the welfare of the people of Virginia rather than on rival banking interests.[48]
>
> The present status of the matter is that of a fight for advantage between The Bank of Virginia and the members of the Virginia Bankers Association. They are alarmed by the growth of the former and by its apparent inclination to extend its operations into new localities, and they want a law to protect them."[49]

The "main contenders" in the branching controversy were the Virginia Bankers Association, the advocate for a ban on

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[48] It is noted that the "welfare of the people" in the 1920's and 1930's was nowhere nearly as well accepted as a useful criterion for judging the impact of banking legislation on the structure of banking. For example, before the enactment of The Bank Holding Company Act of 1956 and The Bank Merger Act of 1960 Federal statutes provided relatively few guidelines regulating expansion of commercial banks. These statutes now include explicit public interest considerations.

[49] The [Charlottesville, Virginia] Daily Progress, February 7, 1948.

branching, and The Bank of Virginia, whose operations were singled out as typical of the problems inherent in statewide branch banking.[50] Arguments aired in the press against branch banking were that:

a) branch banking created a most dangerous monopoly which must be guarded against;[51]

b) the number of banks in a community must be limited so that each one will be strong enough to protect the people;[52]

c) branch banking created a much greater opportunity for out-of-state control of Virginia financial institutions;[53]

d) the "unit bank" system was "most consonant with the genius of the American people" and was protection against chain or branch monopolies.[54]

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[50] Richmond Times Dispatch, February 9, 1948. Fears of banking monopoly were not a new issue. This argument can be traced back to the 1830's; it involved questions of banks or no banks, and free banking laws or control of bank charters.

[51] Ibid.

[52] Ibid., Note there appears to be a conflict between a) and b), yet both were cited in the same article as arguments against branching.

[53] Ibid., Many references were made to the out-of-state control of The Bank of Virginia. Control was traced through the Morris Plan Corporation, The American General Corporation, The Equity Corporation of New York to the Oceanic Trading Company, Inc., A Panama Corporation.

[54] Richmond Times Dispatch, February 6, 1948.

Arguments aired in the press for branch banking were that:

a) branch banking encouraged unfettered competition and avoided "closed shop for the bankers union";[55]

b) banking service to the people was improved;[56]

c) legislation should not be passed to limit competition, but to encourage it;[57]

d) no legislation should ever be passed in Virginia which was leveled at an individual or specific corporation. Legislation should be aimed at principles.[58]

One observer offered the opinion that the outcome of the 1948 controversy over branch banking was never really in doubt. The contest between The Bank of Virginia and the Virginia Bankers Association was described as a mismatch:

> "The contest appears as uneven as any possibly could be. Not only is the Virginia Bankers Association a powerful organization in its own right, but many members of the General Assembly are most certain to be sympathetic with the intent of the legislation. Checking the membership of the Senate, it appears that a majority of the senators are bank attorneys, bank directors, or bank officials. In the

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[55]<u>Ibid.</u>, February 18, 1948.

[56]<u>Richmond Times Dispatch</u>, February 9, 1948, <u>op.cit</u>.

[57]<u>Richmond Times Dispatch</u>, January 13, 1948.

[58]<u>Ibid</u>.

> House of Delegates, about one-quarter of the members are either officers or directors of banks. Not one member of either the Senate or House, however, is known to be an officer, director, or attorney of The Bank of Virginia."[59]

The anti-branching bill was passed by both the Virginia Senate and House by wide margins and _de novo_ branching or merger on a statewide basis was prohibited.[60]

With regard to the reporting of the branching issue in the press two points require comment. First, while both the pros and cons of branch banking were aired, the great preponderance of editorials supported The Bank of Virginia.[61] Second, it was clear that the great majority of the arguments cited in the press for and against branch banking were oversimplified.

IV. THE 1948 LEGISLATION

Changes to the Virginia Code enacted in 1948, which remained in effect until 1962, eliminated _de novo_ branching in cities having a population of 50,000 or more. _De novo_ branches were restricted to the parent-bank city, town, or

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[59] _Richmond Times Dispatch_, January 23, 1948.

[60] _Richmond Times Dispatch_, February 17, 1948. The bill passed the House by a vote of 70 to 22.

________ _____ ________, February 26, 1948. The bill passed the Senate by a vote of 30 to 8.

[61] Cf. Appendix (B), p. B-11, n. 6. According to the records of The Bank of Virginia there were 22 editorials for and none against the position of the proponents of branching.

village;[62] merger or purchase[63] to the same or adjoining county of the parent bank, or of banks located within 25 miles of a parent bank. The net result of this legislation was to eliminate opportunities for expansion of banks outside of their home areas.

The legislation specified that the State Corporation Commission was permitted to authorize banks having paid-up and unimpaired capital and surplus of $50,000 or more to branch:[64]

a) within the limits of the city, town or village in which the parent bank is located;

to merge or purchase a bank:

a) within same or adjoining counties or a bank located within a distance of twenty-five miles of a parent bank, provided that the banks shall have been in operation for a period of five years or more, except that the

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[62]"Town or village" is considered the same as being in the county for definition of location under the Virginia banking code. The significant location distinction is between "city" and "county".

[63]Under Federal and Virginia codes there is no real distinction between merger, purchase, or consolidation of assets.

[64]Cf. Appendix (F), Branching Provision of the 1948 Legislation (excerpts from the Code of Virginia 1950).

State Corporation Commission under certain conditions may waive this time requirement.

The 1948 legislation contained a "grandfather" clause specifying that the restrictions did not apply to branch banks established prior to June 29, 1948; nor to branches already authorized by the Commission, but not yet opened. The effect was to allow all of the branches of The Bank of Virginia in the cities of Newport News, Norfolk, Petersburg, Portsmouth and Roanoke to continue in operation.

In addition the 1948 legislation required that bank expansion meet certain conditions not included under the previous legislation. Specifically, the State Corporation Commission was permitted to authorize *de novo* branches and mergers, "when satisfied that public convenience and necessity will thereby be served."[65] Thus, for the first time, the state law contained an explicit public service requirement for expansion.

V. THE 1949-1962 PERIOD

In the 14 years following the 1948 legislation there were efforts to liberalize branching. In July 1961, the *Richmond Times Dispatch* carried the headline: "Curbs on Bank of Virginia Boomerang--Competitors Feel the Pinch of the 1948

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[65] *Ibid.*, p. F-2.

Laws." Six months later it carried another headline reading: "Virginia Banks Hamstrung--Laws Curb Expansion."[66] As implied by these headlines, Virginia bankers were finding it increasingly difficult to control their own destiny. This resulted from a number of developments which were causing some bankers to reappraise the branching issue. Specifically, the developments in question were industrial and urban growth throughout the state, growing competition from large out-of-state banks to the north and south and growing concern over the expansion of bank holding companies in the state.

Industrial and Urban Growth

During the years 1948-1962 the state was making a rapid transition from a rural economy to an industrial and urban economy. For instance, in 1950 more than 50 percent of the population of Virginia lived outside metropolitan areas, but by 1960 more than 56 percent lived in urban centers. During this period population in the metropolitan areas increased seven times faster than the remainder of the state, and wages and salary income far out-stripped farm income. This rapid growth of Virginia's urban and industrial communities was placing increasing pressures on banks in the state, whose own growth was restricted.

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[66] Richmond Times Dispatch, July 2, 1961; and Richmond Times Dispatch, January 14, 1962.

Growing Out-of-State Competition

In the early 1960's banks in North Carolina, Maryland, and the District of Columbia were larger than banks in Virginia. The greater lending ability of these banks was alleged to be the reason for the increasing frequency of the financing of large commercial and industrial projects in Virginia by out-of-state banking institutions. For instance, the construction of The H. H. Porter Company, $2,650,000 electrical transformer plant at Lynchburg, and its $1,500,000 to $2,000,000 Disston Saw Division in Danville were financed by a North Carolina Bank.[67]

To compete for these larger lines of credit, Virginia's bankers saw the need to become larger banking units. In support of this position the presidents of three large Richmond banks were quoted as saying:

> "Large industries need large credit lines. The biggest bank in Virginia can offer only $1,550,000. Or consider this: Richmond has four of the six largest banks in the state. Yet all four combined can offer an industry no more than $4,950,000. By contrast, in any of 15 North Carolina cities an industry can obtain five million dollars from a single bank."[68]

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[67] Richmond Times Dispatch, July 2, 1961.

[68] Richmond Times Dispatch, January 14, 1962, op.cit.

Growing Holding Company Competition

Virginia bankers also were faced with increasing competition from a new source, bank holding companies. Expansion of these institutions was not regulated under the Virginia banking code. They were extending their operations, primarily in Northern Virginia, by acquiring banks as affiliates.[69] In this manner the acquired banks did not become branches, but remained separate units of the holding company under Federal Laws and under the supervision of the Federal Reserve System. Consequently, holding companies had a competitive advantage over banks with regard to expansion:

> "The two biggest banks in Winchester will be acquired by holding companies, if present negotiations are successful, and Virginia bankers will have another reason to ponder their course for the future...
>
> Group banking--or holding company banking--is increasing in Virginia and many bankers believed there will be more important acquisitions by the holding companies in the months ahead.
>
> This growth is occurring while many Virginia banks are in a straitjacket. The big commercial banks, which are

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[69] Two holding companies were becoming quite active in Virginia:

(1) Financial General Corporation. Financial General was originally established in Virginia in 1925 under the name of The Morris Plan Corporation of America: this was the original Morris Plan holding company.

(2) The First Virginia Corporation. First Virginia was incorporated under the laws of Virginia on October 21, 1949 as Mt. Vernon Insurance Agency, Inc. Its name was changed to The First Virginia Corporation on December 7, 1956.

> closely associated with the Virginia economy and vital to it, are unable to expand because of the highly restrictive branch banking law in Virginia."[70]

In addition holding companies were able to pool their lending resources, thereby, providing larger lines of credit for the expanding industrial base of the state.

The Virginia Metropolitan Plan

In early 1961, spurred by competitive pressures and a changing environment seven banks cooperated in formulating "The Virginia Metropolitan Plan:"[71] (1) First and Merchants National Bank of Richmond, (2) State-Planters Bank of Commerce and Trust of Richmond, (3) Central National Bank of Richmond, (4) National Bank of Commerce of Norfolk, (5) First National Exchange Bank of Roanoke, (6) Peoples National Bank of Charlottesville, (7) Shenandoah Valley National Bank.[72] This was an attempt to acquire the support of other bankers throughout the state for a change to the restrictive branching legislation. The plan envisioned merger between banks having head offices in metropolitan areas, defined as cities of not less

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[70] Richmond Times Dispatch, November 1, 1961.

[71] Cf. Appendix (G), The Virginia Metropolitan Plan.

[72] Cf. Appendix (B), pp. B-12-13.

than 15,000.[73] Prior to the convention of the Virginia Bankers Association in June, 1961, sponsors of this plan visited bankers throughout the state to generate support for changing the law. Their objective was to gain endorsement of the plan at the convention for subsequent presentation to the General Assembly in January 1962.

The Kramer Committee

Opposition to the plan was strong.[74] At the June 1961 meeting of the Virginia Bankers Association the branching issue was referred to a special committee of the Association, The

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[73]This plan proposing a form of limited branching is an example of a lack of a "conceptual scheme" of what banking as an industry should be, i.e., given a "conceptual scheme" implementing legislation should logically follow. This history of the branching issue in Virginia shows no evidence that this concept was debated; therefore, this "key" to the solution of the problem seems to have been overlooked.

[74]One reason for the failure of Virginia bankers to support the Virginia Metropolitan Plan was advanced by Mr. Green, Vice President of First and Merchants, and a member of a group appointed to generate support for the plan throughout the state. The Virginia Metropolitan Plan was primarily sponsored by the larger banks in Richmond. To be accepted as a resolution by the Virginia Bankers Association it needed support of the large number of small banks in the state. It was hard to gain this support because the small banks felt there were dangers inherent in statewide branching systems. Many small bankers were reluctant to give up marketing area protection enjoyed under the 1948 legislation, regardless of the broader economic benefits to the state. Another reason was that the sponsoring bankers did not have sufficient time before the June convention to gather supporters throughout the state.

Kramer Committee.[75] This committee was to report its findings to a special convention of the Virginia Bankers Association in November, 1961 so that the issue could be brought before the 1962 General Assembly. But the special convention provision was voted down under a motion by Mr. Harry Nichols, President of the Southern Bank of Norfolk, and the report was scheduled for the convention the following June. Because of this change any Virginia Bankers Association sponsored action to ease expansion restrictions would be delayed two years, to January 1964, when the Virginia General Assembly would again meet.[76]

Meeting in the late fall and winter of 1961, the Kramer Committee encountered difficulty obtaining a concensus on its recommendations for changes to the branching legislation. A number of alternatives were considered:[77]

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[75] American Banker, August 31, 1961. The committee was appointed by the Virginia Bankers Association President, H. E. Wall, to consist of the following: C. A. Kramer, President, Farmers and Merchants State Bank, Fredericksburg, Chairman; R. Cosby Moore, President, National Bank of Commerce, Norfolk; H. Hiter Harris, Jr., President, Southern Bank and Trust, Richmond; Giles H. Miller, Jr., President, First National Bank, Danville; John S. Fulcher, President, Carroll County Bank, Hillsville; Herbert I. Lewis, President, Bank of Gloucester; and Dr. Charles C. Abbott, Dean of the Graduate School of Business Administration of the University of Virginia.

[76] Cf. Appendix (B), p. B-13, n. 7. Rather than wait two or more years for possible resolution of the branching issue The Bank of Virginia formed a holding company as a means of avoiding the expansion restrictions.

[77] Virginia Bankers Association letter of December 13,

1. The Virginia Metropolitan Plan.

2. Removal of all legal restrictions on statewide branch banking.

3. Authorization of statewide mergers.

4. Regulation of holding companies under Virginia state law to limit their expansion to the same degree as unit banks were limited, i. e., to eliminate the current expansion advantage enjoyed by the holding companies in Virginia.[78 & 79]

The Buck-Holland Bill

On January 18, 1962 a bill favoring statewide branching was introduced in both houses of the General Assembly. It was a complete surprise to the Virginia banking community,

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1961. The "impression" of Mr. R. F. Daniel on the basic approaches to bank expansion which were being considered by the Kramer Committee.

[78]Letter--copy--dated September 8, 1961, to Mr. R. F. Daniel, Executive Vice President of The Virginia Bankers Association, from Mr. David I. Mays, Law Officer of Tucker, Mays, Moore, and Reed. This letter said that legislation to regulate expansion of holding companies in Virginia was not a clear-cut alternative; the present state of the law was that a State may pass legislation more restrictive than the Federal Act in the area of holding companies, but until the issue was decided in the Federal Courts it could not be considered absolute.

[79]Bank Holding Company Facts 1966, Association of Registered Bank Holding Companies, Washington, D. C., p. 32. Holding companies were restricted or prohibited in 16 states, apart from Virginia.

since it came about as the result of independent action of two legislators, Messrs. Buck and Holland.[80]

The Kramer Committee had not reached any conclusions or made any (useful) report to the Virginia Bankers Association prior to the introduction of the Buck-Holland Bill. However, on February 1, 1962, the committee recommended that "in the best interest of the public and banking, the Association support legislation which would provide for permissive statewide merger of banks subject to all other restrictions on branches as are now contained in the existing statutes."[81] This recommendation was apparently intended to remove any major opposition to the Buck-Holland Bill, which with several amendments became law on July 1, 1962. This legislation opened a new era of banking in Virginia. The bankers in Virginia interested in statewide expansion now had three methods to achieve their objective:

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[80] Mr. Buck, of Abingdon, Virginia, was the representative of his area in the House of Delegates. Mr. Holland, of Isle of Wight, was Chairman of the Senate Committee on Banking and Insurance. They both were presidents of relatively small banks in Virginia. Interviews with several bank officers who were closely involved with the legislation indicates that Mr. Buck and Mr. Holland acted on their own, independent of the study being made by the Virginia Bankers Association. In particular, Mr. Holland's motivation was said to be based on the recognition of long run needs of the State of Virginia, and also to give banks a choice between merger and joining a holding company group, Cf. Appendix (B), p. B-14.

[81] Kramer Committee, copy of Minutes of Meetings of Special Committee on Branch Banking, February 1, 1962.

1. Expansion by merger.
2. Expansion by holding company.
3. Expansion by both holding company and merger.

VI. THE 1962 LEGISLATION

Changes in the statutory situation brought by the Virginia Banking Act in 1962 provided an opportunity for statewide expansion of banks. For the first time since 1927 banks could expand into any community in Virginia by merger, regardless of population. Under this legislation, however, additional *de novo* branches could not be established after a merger in areas outside the area of the parent bank.

The State Corporation Commission, when satisfied that public convenience and necessity would be served, was permitted to authorize banks having paid-up and unimpaired capital and surplus of $50,000 or more to branch:[82 & 83]

a) within the limits of the city, town or county in which the parent bank was located;

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[82] Cf. Appendix (H), Branching Provisions of the 1962 legislation (Excerpts from the Code of Virginia 1950 and the 1964 Cumulative Supplement).

[83] A further change in the 1962 legislation was the fact that public necessity for additional banking facilities need not be proved on application to the State Corporation Commission when the proposed new bank will be located in a political subdivision where all banks are owned or controlled by holding companies, or merged systems, or merged systems and holding companies, Cf. Appendix (H), pp. H-2-3.

b) in cities contiguous to the county or city in which the parent bank was located and in counties contiguous to the city in which the parent bank was located; but if the parent bank was located in a city, branches in the contiguous county could not be established more than five miles outside the city limits;

and to merge or purchase a bank:

a) elsewhere in any other county, city or town, provided that the banks had been in operation for a period of five years or more, except that the State Corporation Commission under certain conditions could waive this time requirement; but if the parent bank was located in a city, branches in the contiguous county could not be established more than five miles outside of the city limits.

VII. SUMMARY

During the period 1928-1962 the banking system in Virginia was regulated under three different legislative acts governing expansion by *de novo* branches and merger:

1928 through 1947 - Branches and mergers were authorized in the immediate geographic area of the parent bank and *de novo* branches in cities having a population of not less than 50,000.

1948 through 1961 - Branches and mergers were authorized only in the immediate area of the parent bank.

1962 to date - Branches and mergers were authorized in the immediate area of the parent bank and mergers elsewhere in the State. Within five years after the 1962 legislation there were two large merged systems and four large bank holding companies operating throughout the state. Other significant changes that took place in Virginia during the years 1962-1966 were: (1) more banking offices, (2) fewer banks, (3) larger banks, and (4) higher deposit concentration among the large banks. These developments will be discussed in greater detail in Chapter IV, "The 1962-1966 Period of Expansion."

Banker's attitudes toward branching, their views of The Morris Plan Bank of Richmond and consumer finance, the economic and geographic structure of Virginia, together with the thinking of bankers at the national level were factors which influenced the development of banking in Virginia. The period 1929-1948 saw commercial banks in Virginia enter the field of consumer credit and The Morris Plan Bank of Richmond enter the field of commercial accounts. Yet the commercial banks in Virginia continued to show no interest in branching, while The Morris Plan Bank of Richmond (now The Bank of Virginia) announced plans to continue its inter-city branching program. Thus, "head to head" competition between those for

and against branching was a reason for the passage of legislation in 1948 which restricted expansion of banks to their home office area.

Between 1949-1962 Virginia bankers found it increasingly difficult to control their own destiny. Industrial and urban growth, competition from large out-of-state banks and expansion of bank holding companies in Virginia, were developments causing a reappraisal of the branching restrictions. Recognition of the need for expansion of the Virginia banking system resulted in the enactment of the 1962 legislation permitting statewide mergers.

These developments suggest certain conclusions and generalizations:

A. Until after World War II commercial bankers in Virginia were generally not innovators. Throughout this period they tended to maintain the status quo and resist change. In fact, it was the result of external factors (the depression in the 1930's, the Bank Holding Company Act of 1956, competition and a changing environment in the 1960's) that forced bankers in Virginia away from their traditional posture into branching and the field of consumer credit. Seemingly, the opportunities for public service and profit were not created by Virginia bankers themselves.

B. In order to put the proper perspective on the conclusion that bankers in Virginia were not innovators until

after World War II, it is noted that this same comment was made regarding the banking industry as a whole by George W. Mitchell, a member of the Board of Governors of the Federal Reserve System.

> "Some firms and industries have created a product or service, built up public awareness and acceptance for it, and, using generative, adaptive, and innovative forces from within, have established a role and importance for their own enterprise. The result is a *de novo* industrial-commercial business or complex.
>
> Banking is not such an enterprise or industry. It has a pattern of traditional services, an imposed molecular structure, and a pedestrian operating technology, none of which it could call its own. It has not innovated its service products nor shown much adaptive ingenuity in their promotion. Its favorite image has been a passive conformity to the mores of its better customers. Its competitive aggressiveness has been schizophrenic, with large sectors of the industry advocating or supporting publicly administered price ceilings for time deposits, public prohibitions against the absorption of exchange, and a variety of regulatory devices or postures that by sanction or promise dilute competitive ingenuity."[84]

C. There is no evidence that commercial bankers, as a group, developed (or desired to develop) a "conceptual scheme" of what the commercial banking industry could or should be.

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[84] George W. Mitchell, "Exogenous Forces In The Development of Our Banking System," *Law and Contemporary Problems*, Vol. XXXII, No. 1 (Winter 1967), p. 3.

The legislation in 1962 was the result of the action of two legislators, independent of the Virginia Bankers Association, which was at that time commonly thought to be the authorized channel for the banking industry. This is further evidence that Virginia bankers were presented with opportunities for profit and growth which they themselves had not created. In fact, if they had not been so provincial in 1948, they probably would not have had to reverse their policies in 1962.

CHAPTER IV

THE 1962-1966 PERIOD OF EXPANSION

This chapter describes significant changes that took place in the structure of Virginia banking in the five years after enactment of the Buck-Holland Bill, in 1962. Generally these changes were:

-- Evolution of six statewide banking systems

-- More banking offices

-- Fewer banks

-- Larger banks

-- Higher deposit concentration among the larger banks in Virginia

I. STATEWIDE BANKING SYSTEMS

In 1962 only three banking organizations in the state participated in area wide branching to any extent. The Bank of Virginia with its main office in Richmond operated branches in Petersburg, Newport News, Norfolk, Portsmouth, and Roanoke. The First Virginia Corporation, a bank holding company in Arlington, and Financial General, a holding company in Washington, D. C., operated affiliates in several communities in Northern Virginia.[1] Only the Bank of Virginia, however, with

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[1]Financial General was a holding company registered under the Investments Act of 1940.

branch offices in major population centers in the southeastern, central and southwestern sections of the state had statewide coverage.

By the end of 1966 two merged systems and four holding companies were operating in most of the state's metropolitan areas, regional population centers and some rural communities. The banking systems serving these areas are shown on Table E-II, Appendix (E). The six metropolitan areas, with the exception of Roanoke, were served by at least three systems each; Arlington and Norfolk were each served by five. A holding company, Virginia Commonwealth, served all six.[2]

The four secondary population centers--Charlottesville, Danville, Harrisonburg, Waynesboro-Staunton--and their surrounding counties were not as well covered by the large banking systems. Virginia National Bank operated in all four, but no other system was active in more than one of these centers. Waynesboro-Staunton and Augusta County seemingly had the most system competition with three.

By 1966 statewide banking systems served areas containing more than 62.5 percent of Virginia's population. The six

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[2]Roanoke and the southwestern region of Virginia, as of the end of 1966, were served by the First National Exchange Bank--a large <u>regional</u> banking system. In August 1967 First National Exchange formed what was then Virginia's newest holding company--Dominion Bankshares--with Metropolitan National Bank of Richmond.

metropolitan areas contained 56.3 percent of Virginia's population of 4,525,976; the four regional population centers contained 6.3 percent.[3] In addition, the six statewide systems served many smaller cities, towns, and counties.

The significance of the evolution of statewide systems may be put in even better perspective when it it recognized that Virginia is one of only six states where branching is found on an area wide basis:

> "In discussing the operations of branch banks, it would be most convenient to contrast local branching with branch systems which serve very wide areas. But, unfortunately, for over a century America has had little general experience with even relatively broad branching. In fact, of the 2,797 commercial bank branches, located in counties which were noncontiguous to the head-office county at the end of 1966, four-fifths of them were found in only six states--three adjoining West Coast States: California (47%), Oregon (50%), and Washington (4%), and three adjacent east coast states: North Carolina (14%), South Carolina (5%), and Virginia (5%). On the other hand, there were 33 states which had only ten branches or less in this noncontiguous county category."[4]

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[3] The Bureau of Population and Economic Research, "Estimates of the Population of Virginia Counties and Cities: July 1, 1967," (Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, August 1967), pp. 1-15.

[4] Fischer, American Banking Structure, op.cit., p. 41.

The percentages indicate the [illegible] of branches [illegible] in the state concerned.

Thus, the development of system banking on a statewide basis in Virginia was unique. It appears to have been the result of the branching legislation which prohibited de novo branches or merger more than five miles into a contiguous county, if the expanding bank had a home office in the contiguous city.[5] The "five mile" limit seemingly influenced some of the larger city banks to expand statewide rather than on a regional basis. However, it is not clear from the historical record of the 1962 legislation that consideration was given to the advantages of statewide versus regional expansion. In fact, the branching controversy in the Virginia Bankers Association and the clear lack of any plan by any of the interested parties for the development of banking in Virginia, prior to the Buck-Holland Bill, suggests that the evolution of Virginia as one of six states with any measure of statewide banking was more by chance than by design.

II. MERGERS

The acceleration in the trend toward fewer banks in Virginia was caused by the wave of mergers following the 1962 legislation--between July 1, 1962 and December 31, 1966 there were 70.[6] These involved one of every four of the 302 banks

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[5] Cf. Appendix (H).

[6] Bureau of Population and Economic Research, "Virginia

in Virginia in 1962. Thirty different banks acquired other banks by merger. Figure IV-1 illustrates the increase in merger activity after the 1962 legislation.

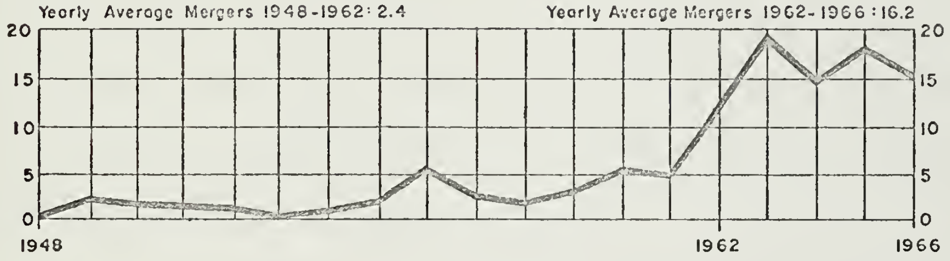

FIGURE IV-1

NUMBER OF COMMERCIAL BANK MERGERS IN VIRGINIA 1948-1962[7]

The decrease in the number of banks would have been greater except for an offsetting increase in the number of new bank formations. During the period 1962-1966, 31 new banks were established compared to 21 for the previous 14 year period. According to bank executives interviewed, this increase was to

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Banking Survey For Years of 1947, 1961 through 1966," unpublished statistics (Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, 1966).

[7]Data for Figure IV-1 from Banking Markets Unit, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Number of Commercial Banks and Branches by States, 1936-1964 and Annual Supplements.

be attributed to: (1) the liberal attitude of the then Comptroller of the Currency (Saxon) toward bank expansion, (2) the need for additional banking facilities in Virginia's fast growing urban areas, and (3) speculation on bank location in anticipation of a later merger. In addition, 27 holding company acquisitions--when viewed as a substitute for merger--worked to keep the total number of banks in Virginia higher than it otherwise might have been in that holding company acquisitions continue as separate banks.

Merger Characteristics

Location. Both metropolitan and non-metropolitan banks were active as the acquiring bank. Three out of four of the banks acquired were in non-metropolitan areas. Figure IV-2 summarizes the merger activity by location:

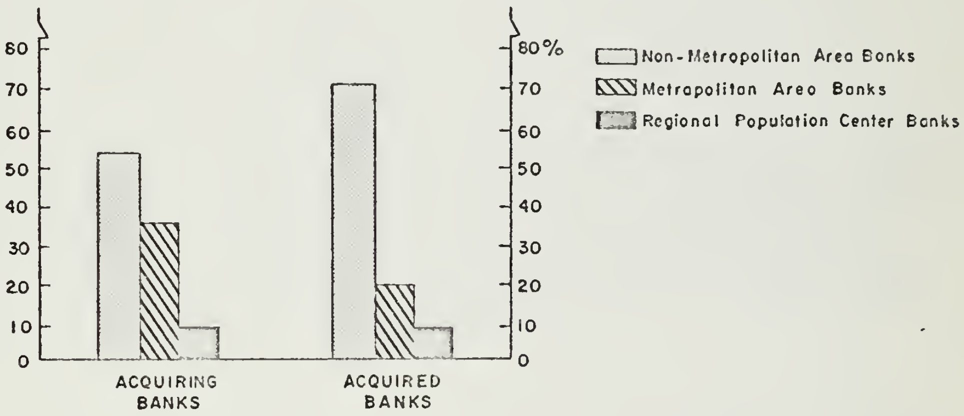

FIGURE IV-2

PROFILE OF ACQUIRING AND ACQUIRED BANKS BY LOCATION IN VIRGINIA, JULY 1962 TO DECEMBER 31, 1966[8]

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[8]Data for Figure IV-2 from the Bureau of Population and

Type and Size of Bank. Individual banks accounted for 63 percent of the mergers; holding companies accounted for 7 percent; statewide merged systems, 30 percent.[9] Generally the size of the acquiring bank was considerably larger than the acquired bank. This result was not unusual since three out of four of the merged banks were in non-metropolitan areas. Table IV-1 shows the range, average and median size of acquiring and acquired banks.

TABLE IV-I

RANGE, AVERAGE, AND MEDIAN DEPOSIT SIZE OF ACQUIRING AND ACQUIRED BANKS IN VIRGINIA, JULY 1, 1962 TO DECEMBER 31, 1966

	Acquiring Bank(millions)	Merged Bank(millions)
Average	$ 81	$ 11
Median	$ 28	$ 8
Range	$1.6 to 536	$ .5 to 187

NOTE: Bureau of Population and Economic Research, "Virginia Banking Survey For Years of 1947, 1961 through 1966," unpublished statistics (Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, 1966.)

Economic Research, "Virginia Banking Survey For Years of 1947, 1961 through 1966," unpublished statistics, Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, 1966.

[9] Bureau of Population and Economic Research, "Virginia Banking Survey for Years of 1947, 1961 through 1966," loc.cit.

III. HOLDING COMPANY ACQUISITIONS

In Appendix (E) a comparison of Tables E-III and E-IV shows that during the years 1962-1966:

a) the number of holding companies doubled;

b) the number of banks affiliated with holding companies grew from nine to 38;

c) the number of banks affiliated with holding companies increased from 2.9 percent to 15.1 percent of the total number of banks in Virginia;

d) by December 31, 1966, holding company affiliates and their branches accounted for approximately 27 percent of the total banking offices in the state;

e) between December 31, 1961 and December 31, 1966 holding company deposits, as a percentage of total state deposits, increased from 5.91 percent to 28.11 percent.

Appendix (E), Table E-V shows that because of the rapid growth of holding companies four such organizations were among the ten largest banking organizations in Virginia, as of December 31, 1966. These were United Virginia Bankshares, Virginia Commonwealth Bankshares, First Virginia Corporation, and Financial General Corporation--respectively number one, four, five, and seven.

This growth of both holding companies and merged systems into statewide banking organizations was a unique aspect of

the 1962-1966 period of banking expansion in Virginia. One author has cited several benefits stemming from this: (1) Virginia banks are now better able to compete with banks in neighboring states for large loans, (2) more of the state's business can be financed from sources within the state, and (3) statewide branching has resulted in greater mobility of funds, diversification, a large number of better qualified management personnel, and management personnel with special skills.[10]

IV. FEWER BANKS--MORE BANKING OFFICES

During the years 1962-1966 changes in the banking structure in Virginia resulted in a reduction in the number of banks, an increase in the number of branches and a steady growth in the number of total banking offices. With one exception, these were consistent with the trends in the national banking system. The sole divergence was in the number of banks. Figure IV-3 illustrates a 16.89 percent decrease of banks in Virginia, whereas the number of banks in the U. S. increased 2.57 percent. On the other hand, branches in Virginia increased 91.25 percent, more than three times the increase of branches for the nation as a whole.

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[10] Harmon H. Haynes and Charles F. Phillips, Jr., "The Banking Structure of Virginia," Washington and Lee Law Review, Volume XXV, No. 1, Spring 1968, pp. 29-30.

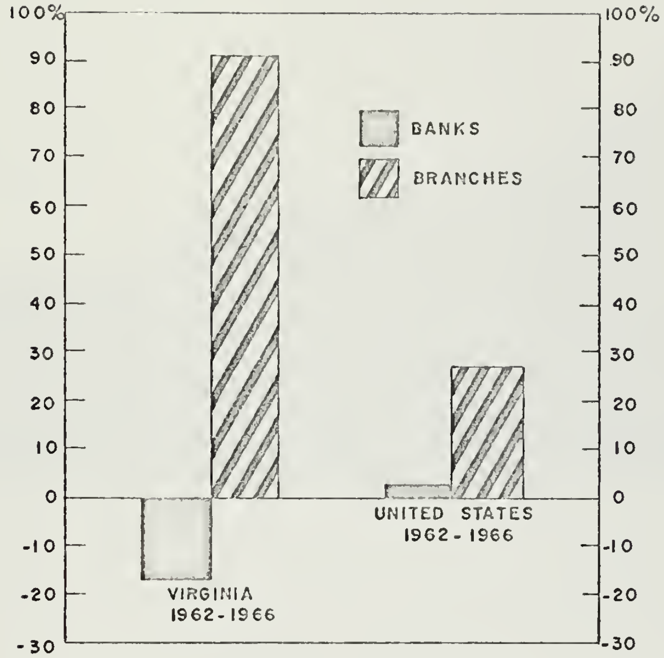

FIGURE IV-3

CHANGES IN BANKS AND BRANCHES IN VIRGINIA AND U. S. 1962-1966
(FROM APPENDIX (E), TABLES E-VI AND E-VII)

The effect of the 1962 legislation on the rate of change in the number of banks and of branches was substantial. The average annual rate at which the number of banks decreased was 10.2 per year for the period 1962-1966, compared to .8 per year for the prior 15 years--more than a ten fold increase. The average annual rate at which branches increased was 49 per year compared to 18 per year for the prior 15 years--approximately a 2 1/2 fold increase. Figure IV-4 illustrates the trend in banks, branches, and total facilities.

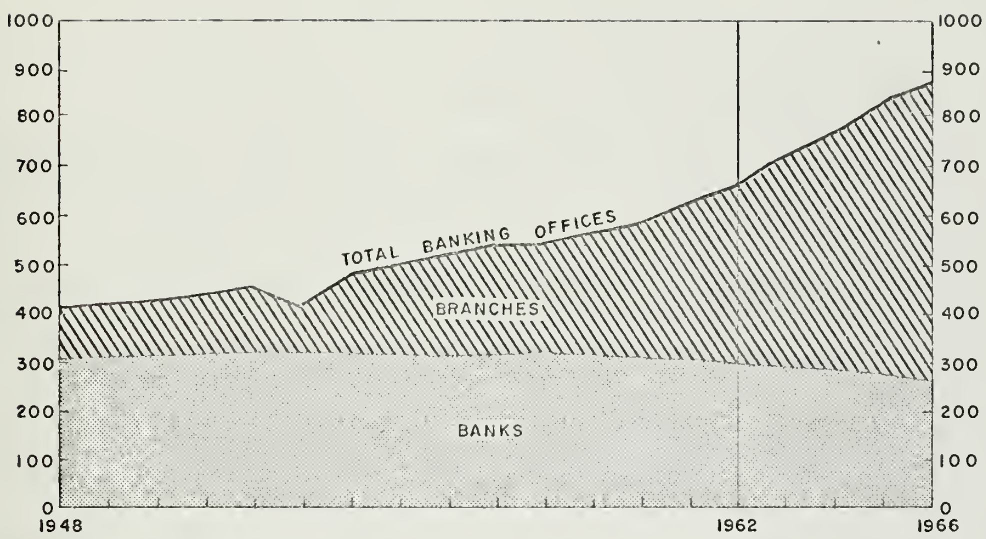

FIGURE IV-4

CHANGES IN BANKS AND BRANCHES IN VIRGINIA 1948-1966
(FROM APPENDIX (E), TABLES E-VI AND E-VII)

V. LARGER BANKS

As discussed in Chapter III, Virginia bankers--during the latter 1950's and early 1960's--had seen a need for larger banking organizations with larger lines of credit to meet out-of-state competition, and to serve better the growing industrial community in Virginia. By 1966 these objectives had been met.

The relative size of Virginia's largest banks increased compared to banks in neighboring states and the District of Columbia. For instance, in 1961 no banks in Virginia were

among the nation's largest 100, but by June 30, 1966 there were two: First and Merchants and Virginia National.[11]

In 1961, Wachovia Bank and Trust Company had deposits approximately 2.8 times larger than First and Merchants, Virginia's largest bank; Riggs National Bank and Maryland National Bank were 1.9 times larger in terms of deposits. However, by the end of 1966 Virginia's largest bank had gained in deposit size: Wachovia was only 1.8 times larger; Maryland National 1.5 and Riggs 1.3 larger in terms of deposits. Consequently, the largest banks and banking organizations in Virginia, by 1966, had gained substantially against their regional competitors.[12]

Higher Deposit Concentration In The Larger Banks

From 1962-1966 deposit concentration among the larger banks in Virginia increased. By December 30, 1966, the largest five banks held 36 percent of total state deposits, up from 25 percent five years earlier.[13] Thus, the 1962 legislation

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[11] American Banker, August 1, 1966, "300 Largest Commercial Banks in the United States June 30, 1966." First and Merchants ranked 85th in deposit size and Virginia National ranked 90th.

[12] Cf. Appendix (E), Table E-V. Considering banking organizations holding companies operating in Virginia at the end of 1966 rank in size of deposits: first, fourth, fifth, and seventh.

[13] Cf. Appendix (E), Table E-I, E-VIII, and IX show: (1) ranking of banks in Virginia by deposit size for 1947-1961-1966; (2) percentage of deposits held by the largest five,

reversed a 1948-1961 trend toward lower concentration, which had been the consequence of the restrictive legislation enacted in 1948.[14]

Compared to other states, Virginia has a relatively small amount of deposit concentration. In 1965 in California, Rhode Island, New York and Oregon, what Fischer defines as "large commercial banks" held over 80 percent of the state's deposits, whereas the large banks in Virginia held only 41.9 percent.[15] Though deposit concentration in Virginia is still considerably less than in these states, a further increase has been viewed by some bankers as a constraint on the future growth of banks. Size and concentration, rightly or wrongly, have thus become important considerations for management in its planning of future expansion.

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ten, and twenty banks for 1947-1961-1966. Table E-V shows the ranking of banking organizations in Virginia by deposit size and percentage of deposits held for 1966.

[14]The Bank of Virginia, said to be the object of the 1948 branching restrictions, grew faster during the period of restricted branching 1948-1961, than any of the five larger banks. By the end of 1961, The Bank of Virginia had moved up from sixth to fourth largest in the state. The Bank of Virginia's higher growth rate may be attributed, in part, to the fact that the 1948 legislation left it with the only branch organization in five of Virginia's six major population centers.

[15]Fischer, American Banking Structure, op.cit., pp. 334-35.

> "Now after a five year wave of mergers and acquisitions Federal regulators seem to be signaling the concentration among larger banks here has gone just about far enough.... Most bankers seem resigned to the fact that regulatory authorities will not allow any new formation of banking giants, nor allow any of the big ones now existing to make any really sizable acquisitions. What constitutes "giant" or "sizable" are, of course, matters of conjecture. But the interpretation is of considerable interest to bankers here and elsewhere who must try and fathom the Federal Reserve's ruling on "potential competition," a concept first spelled out in a ruling this spring against a new acquisition by a Virginia holding company."[16]

IV. INFLUENCE OF THE 1962 LEGISLATION

A significant aspect of the 1962 legislation was that it worked with the changing economic climate in Virginia, as against the 1948 legislation which obstructed the on-coming economic developments of the 1950's and early 1960's. In 1962 the economic pressures finally "burst" the legislative constraint, which clearly was not in accordance with the needs or desires of the economy. Consequently with the change in the legislation in 1962 several results could be anticipated. First--in the short run--there would be "abnormal" or even "revolutionary" speed in the changes to the banking structure, from a great

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[16] American Banker, July 24, 1967.

rush to acquire banks in satisfaction of a pent-up demand. Second--in the long run--acquisitions would be governed by "normal" forces of expansion and competition, presumably mostly related to the growth of the state. Third, the "advantages" and "disadvantages" of each form of expansion--direct merger and holding company--will not necessarily remain the same in the short run and long run.

CHAPTER V

THE LITERATURE: ADVANTAGES AND DISADVANTAGES OF EXPANSION BY WAY OF THE HOLDING COMPANY AND DIRECT MERGER

This chapter draws on the literature to develop a "theoretical framework" of the alleged advantages and disadvantages of expansion by way of the holding company and direct merger. In subsequent chapters this framework will be used to examine management's choice of the form of organization by comparing those specific points management thought important with the literature.

Throughout this chapter, as each characteristic is identified, one or more sources are cited. In cases where there appear to be conflict, disagreement, or uncertainty concerning particular characteristics, opposing views are identified. Where possible a generalized summary of the "weight of the evidence or arguments" is made to indicate the concensus.

The literature contains no consistent or systematic method for grouping the alleged advantages and disadvantages. Consequently, these are organized into four functional areas for the purpose of discussion: (1) operational and organizational, (2) financial, (3) marketing, and (4) legal. Some characteristics apply to two or more of the functional areas and, where significant, they are discussed under each. For

example, an operational and organizational characteristic may result in, or stem from, marketing or legal considerations.

Comparisons commonly made in the literature are between a holding company and a unit bank, or between a merged system and a unit bank. There are relatively few direct and comprehensive comparisons between the two forms.[1] For this reason, numerous advantages are cited as common to both forms of organization, on the basis of a comparison of each to a common standard--a unit bank.

I. OPERATIONAL AND ORGANIZATIONAL CHARACTERISTICS

In the literature operational and organizational characteristics of holding companies and merged systems were normally discussed with regard to the production functions of a bank.

Economies of Scale

The general opinion was that benefits from economies of scale exist in both the holding company and merged form of banking organization.[2] Economies of scale were commonly defined

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[1] Lewis B. Flinn, Jr., "Holding Company Versus Branch Banking in Virginia" (unpublished thesis, The Stonier Graduate School of Banking, Rutgers, New Brunswick, June 1967), pp. 1-122. Flinn's thesis is an example of an exception to this finding.

[2] Gerald C. Fischer, Bank Holding Companies (New York: Columbia University Press, 1961), pp. 87, 119 and 128; Palmer

as a reduction in the cost of various functions--loans, checking accounts--as the number of units increase. One statement, on which most commentators agreed, was that close integration of the typical branch operation makes greater economies possible than those achieved in a holding company.[3] Yet, seemingly a holding company having affiliates with a large branch system might achieve economies comparable with those of a similar sized merged system.

Research in economies of scale includes size to output studies, and size to performance variable studies.[4] Findings in each category generally supported the view that economies of scale do in fact exist.

T. Hogenson, The Economies of Group Banking (Washington, D.C.: Public Affairs Press, 1955) pp. 142-43; Frederick W. Bell and Neil B. Murphy, "Returns to Scale in Commercial Banking," Bank Structure and Competition (Chicago: Federal Reserve Bank of Chicago, 1967), pp. 118-76; Federal Reserve Bank of Boston, "Economies of Scale in Commercial Banking," Business Review, March 1967, pp. 3-11; April, 1967, pp. 2-10; June 1967, pp. 13-19; July 1967, pp. 12-19; David A. Alhadeff, Monopoly and Competition in Banking, (Berkely: University of California Press, 1954), Chapter VI; and George J. Benston, "Branch Banking and Economies of Scale," Journal of Finance, Vol. XX No. 2, May 1965, pp. 312-31.

[3]W. Ralph Lamb, Group Banking A Form of Banking Concentration and Control in the United States (New Brunswick, New Jersey: Rutgers University Press, 1961), pp. 236-37.

[4]"Size to output studies" relate to output in terms of the production functions of banks, i.e., loans, checking accounts, savings accounts.

"Size to performance variables" relate to performance

<u>Size to Output Studies</u>. The validity of "size to output studies" was said in the literature to suffer from the failure of research to measure bank output with a common yardstick. As reported by a recent survey of banking research, conflicting results, inadequate data, and imperfect methodology of studies make it difficult to determine what size of bank is most efficient.[5] In all probability, economies of scale "will depend on the composition of the services rendered so that at best there may be only an optimal distribution of size of banks rather than a single optimal size."[6]

One conflicting piece of evidence was the view that diseconomies tend to offset any economies of scale, which might be less important than diseconomies in the branch structure. Therefore, this view held that branching might not be supported solely on a cost advantage basis.[7] However, a later study reported that diseconomies in branching could be overcome by

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<u>variables</u> in terms of commonly used measures of bank operating performance, i.e., ratio of earnings to assets.

[5]Federal Reserve Bank of Chicago, "Competition in Banking: What is Known? What is the Evidence?" <u>Business Conditions</u>, February 1967, pp. 7-16.

[6]<u>Ibid</u>., p. 15

[7]Paul M. Horvitz, "Economies of Scale in Banking," <u>Private Financial Institutions</u> (Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1963), pp. 1-54; and Benston, <u>op</u>.<u>cit</u>., pp. 312-31.

growth as long as fairly wide branching was permitted, perhaps on a statewide basis.[8]

<u>Size to Performance Studies.</u> Research findings in "size to performance variable studies" also supported economies of scale. Larger banks were said to have higher earnings to assets and capital although they tend to: (1) pay higher average rates on savings, (2) charge lower average rates on loans, and (3) have a higher ratio of time to total deposits. Also, economies of scale were supported in group banking by evidence "that their rate of return on total capital funds for 1957 was 10 percent higher than the reported net profits for all commercial banks."[9] Nevertheless, findings regarding size to performance variables were said to be biased in that the greater earnings of larger banks result, in part, from the different nature of their operations aside from scale.[10] For instance, larger banks may serve large commercial accounts with smaller unit administrative costs.

The weight of the evidence suggests that economies of scale exist in large banks of both forms. However, economies of scale may be greater in a branch system because closer integration of operations is possible. As an example, trust

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[8]Paul M. Horvitz and Bernard Shull, "The Impact of Branch Banking on Bank Performance," <u>Studies in Banking Competition and The Banking Structure</u>, Office of the Comptroller of the Currency (Washington, D. C.: U. S. Treasury Department, 1966), pp. 141-86.

[9]Lamb, <u>op.cit.</u>, p. 236.

[10]Federal Reserve Bank of Chicago, "Competition in Banking: What is Known? What is the Evidence?," <u>op.cit.</u>, p.15.

departments and loan and investment portfolios in holding company affiliates cannot be integrated; nor is it likely that holding company affiliates can obtain comparable integration in the checking account area because they remain separate banks. However, measurement of this apparent advantage is difficult, if not impossible, given the limitations of current research methodology.

Organizational Characteristics

The concensus of the literature was that certain organizational characteristics of both the holding company and merged form facilitate efficiency in operations.[11] Efficiencies were specifically attributed to the benefits of centralization and specialization; others were attributed to greater organizational flexibility.[12] However, there was no evidence which clearly pointed to the relative importance of these contributing elements.

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[11] Robert J. Lawrence, The Performance of Bank Holding Companies (Washington, D. C.: Board of Governors of the Federal Reserve System, June 1967), pp. 5-6; Marcus Nadler and Jules I. Bogen, The Bank Holding Company (New York University: Graduate School of Business Administration, 1959), pp. 18-19 and 24-29; and Federal Reserve Bank of Boston, "Economies of Scale in Commercial Banking," loc.cit.

[12] In this sense efficiency stems from centralization and specialization as opposed to economies of scale, i.e., an organization can achieve benefits from these factors without an increase in the size of its operations.

Reasons typically cited for attaining efficient operations are grouped for the purpose of this discussion into the following categories: (1) centralization of common functions, (2) improved quality of management, (3) extension of specialized services to members of the system, (4) the adoption of identifiable operating improvements uniformly throughout the system, (5) greater organizational flexibility, and (6) better or improved management control.

Centralization of Common Functions. Operating efficiencies stem from centralization of certain activities.[13] For instance, centralized purchasing of supplies and equipment, both consumables and capital items, may result in greater quantity discounts and lower administrative cost per unit of purchase. Economies may also result from centralization of services, such as: (1) audit, (2) legal counsel, (3) accounting, (4) tax assistance, (5) operations assistance, and (6) advertising. On the basis of the literature it is thought that tangible and measurable efficiencies are possible in both the holding company and merged system, as contrasted to a unit bank. However, centralization of functions in a merged system which cannot be combined in a holding company may lead to greater economies in the merged system.

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[13] Hogenson, op.cit., p. 143; and Nadler and Bogen, op.cit., p. 24.

Improved Quality of Management. An often cited advantage of both forms is that these larger organizations are better able to attract and hold superior managerial talent than smaller unit banks. With few exceptions, this advantage is discussed in the context of banking's acute problem of "management succession". For instance, it is argued that of all of the difficulties facing bank management in the United States today, the personnel problem is one of the most significant. To illustrate this point, the president of the Federal Reserve Bank of Philadelphia has said that the failure of bankers to prepare younger men for succession is a prime reason for bank mergers.[14] But, to combat this problem large banks--of both forms--benefit from their superior managerial "drawing power", which is generally attributed to more opportunities for advancement, more job responsibilities, better salary scales and wider benefits. Also, they have a greater capability to employ specialists in areas such as: (1) legal, (2) tax, (3) accounting, and (4) personnel. However, the literature does not indicate that either form is superior with respect to hiring and holding first class management talent or specialists.

Extension of Sepcialized Services Throughout the System. Another widely cited advantage of both the holding company and

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[14] Fischer, Bank Holding Companies, op.cit., p. 96.

merged system was that these larger banking organizations have greater opportunities to extend, or share, services and special skills among all units of the organization. Services ordinarily cited were: (1) auditing, (2) appraising, (3) investment counseling, (4) safe deposit, (5) trust, (6) legal, (7) accounting, (8) purchasing, (9) research, (10) credit services, (11) tax, (12) employee compensation and benefit plans, and (13) institutional advertising.[15] Here again, however, the literature provides no basis for concluding that either form was better able to extend specialized services throughout its system.

The Adoption of Identifiable Operating Improvements Uniformly Throughout the System. An important, but less widely discussed advantage is that units in both forms might benefit from the successes and mistakes of other units.[16] Executives throughout "a system" have opportunities to exchange ideas and discuss common problems. This results in a beneficial cross-fertilization of ideas concerning operating improvements, as well as solutions to general operating problems.

In addition, the audit of operating units--by a holding company, lead bank, or home office--is often said to contribute

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[15] Fischer, Bank Holding Companies, op.cit., p. 87; and Nadler and Bogen, op.cit., p. 24.

[16] Fischer, Bank Holding Companies, op.cit., p. 87.

to operating efficiencies.[17] Through internal performance evaluation like units can be compared and unit managements encouraged to improve their performance. In this way the less active or progressive banks or branches may be identified and, hopefully, moved along at a faster and more efficient pace. From what the literature says the holding company and merged system seem equally capable of sharing operating improvements throughout their systems. However, performance evaluation may be less difficult in the holding company because each affiliate, as a separate corporation, is operated and reported as an individual "profit center". By the way of contrast, the merged system would have to make internal accounting provisions to report each branch as a profit center, in addition to reporting on the system as a whole.

Organizational Flexibility. The holding company is said to have more possibilities for organizing the production of banking services than an independent bank, that is, the "produce versus buy" alternative gives them greater flexibility.[18] An affiliate may produce its own banking services, buy from the lead bank in the holding company, buy from a nonbanking subsidiary of the holding company, or buy from a nonaffiliated bank.

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[17] Hogenson, op.cit., p. 140.

[18] Lawrence, op.cit., p. 5.

Management Control. A fundamental difference between the holding company and the merged system was alleged to be in the area of management control. This stems from the special relationship that exists between the holding company and its affiliate. "By its very nature, this parent-subsidiary relation can exist only in holding company banking, and not in either unit or branch banking."[19] Each affiliate in a holding company system retains independent bank status with a board of directors and a president. Here, however, a distinction needs to be made between affiliates that are 100 percent owned and affiliates less than 100 percent owned. Where 100 percent ownership exists, management relationships are probably not much different than in a merged system, even though the legal structure is different. Where less than 100 percent ownership exists, the separate legal status of affiliate directors can and probably does, from time to time, affect management relationships and operating policies. By the way of contrast, a branch system has only one board of directors and one president for the entire system, and does not face the problem of "minority interests" in units throughout the system.

The literature does not indicate that one form of banking organization is _clearly_ superior to the other in terms of management control. A recent unpublished thesis indicates that

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[19] Nadler and Bogen, _op_._cit_., p. 21

effective use of decentralization in merged systems is possible and desirable.[20] This thesis cites the advantages and disadvantages of decentralization.

Generally, the conclusions were that: (1) good organization is essential to good management, (2) behind an organization there must be a philosophy of management, (3) management must choose and balance the advantages and disadvantages of centralization versus decentralization, but that (4) decentralization is the better way to organize because it stimulates managers, gets better results, and develops initiative and creativity.

The view that merged systems can also make effective use of decentralization is contrasted to the argument that a basic advantage of the holding company is its decentralized corporate structure. Here it is argued that the holding company has the opportunity to decentralize management to a greater extent than is posssible under a branch system, where the tendency is to concentrate authority in the head office.[21] However, management organization and policies may tend to minimize the effects of this basic characteristic.[22] For instance, centralized management control is possible if

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[20]Schmitz, Michael J., "Centralization versus Decentralization in a Branch Banking Organization" (unpublished thesis, The Stonier Graduate School of Banking, Rutgers, New Brunswick, 1964).

[21]Flinn, op.cit., pp. 77 and 82.

[22]Nadler and Bogen, op.cit., pp. 30-31. The authors

management policy is to restrict the operational autonomy of affiliates. On the other hand, a high degree of decentralization is possible where the affiliates have broad policy and operating responsibilities.

> "Group banking permits a wide variety of organization patterns since each affiliated bank must have its own board of directors and officers who are charged by law with the responsibility for operating their own banks. As a result, the member banks may be run as independent institutions, policies may be set through consultation with the holding company management or the parent's officers may exert a very large measure of influence over management of the subsidiary."[23]

From the arguments in the literature it seems that the only clear difference between the holding company and merged form is that the independent corporate structure of the holding company assures, at least in theory, more autonomy for its affiliates than does the branch organization for its branches. And to the extent holding company affiliates are not 100 percent owned their separate legal status can and probably does distinctly affect management control.

III. FINANCIAL CHARACTERISTICS

Larger Lines of Credit

The amount of credit extended to any single customer is limited by banking laws. The limit is set at 10 percent

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preface this point with the statement that decentralization is a dominant trend in business management today, p. 23.

[23] *Ibid.*, p.31.

of the capital and surplus and undivided profits for individual national banks and 15 percent of capital and surplus for state chartered banks in Virginia.[24] Expansion of the size of individual banking systems inevitably provides an increased capital base necessary for the extension of larger lines of credit.

Mobility of Credit

The critical question is whether the two forms of organization provide equal mobility of credit. On this the literature suggests--understandably--that both have greater mobility than an independent bank. For example, in the holding company the combined lending power of all affiliated banks is available to any local member institution to accommodate the financing requirements of large customers.

In the merged system the credit line of any branch, regardless of size, is considered to be the same as the system as a whole. The full lending power of the home office is theoretically available at any branch office.

> "The branch system provides for mobility of funds and can shift excess reserves for lending through other

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[24] The Bureau of Banking of the State Corporation Commission, Laws of Virginia Relating to Banking and Finance, (Charlottesville, Virginia: The Michie Company, 1966), p. 27. The 15 percent limit for state chartered banks in Virginia is specified in Article 7, Section 6.1-61.

> outlets of the system. Thus, there are offices of some branch banks which have loan-deposit ratios of over 100 percent."[25]

In an independent unit bank, credit mobility is less because similar arrangements made through correspondents depend on the closeness of the correspondent relationship, and it may vary so much as to limit the extent of this form of lending.[26]

When comparing the two forms the mobility of funds seemingly is potentially greater in the merged system because of certain legal and operating constraints on the holding company. For instance, until repealed in 1966, Section 6 of the Bank Holding Company Act of 1956 limited credit mobility by requiring loan participation within the holding company to be made "at the outset" of the loan transaction. Now, however, it appears this restriction is eliminated.

> "But Section 23a of the Federal Reserve Act was amended so that its restrictions on banking affiliates were also applied to the subsidiaries of bank holding companies. These restrictions state that a banking affiliate may not loan or otherwise extend credit to another affiliate or to the holding company if the total amount of loans or extension of credit to the other affiliate exceeds 10 percent of the lending affiliate's capital and surplus or if the

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[25] Bernard Shull and Paul M. Horvitz, "Branch Banking and The Structure of Competition," Studies in Banking Competition and The Banking Structure, Office of the Comptroller of the Currency (Washington, D.C.: U. S. Treasury Department, 1966), p. 135.

[26] Lamb, op.cit., p. 239.

> total amount of loans or extensions of credit to all affiliates (including the holding company) exceeds 20 percent of the lending affiliate's capital and surplus. (Under the original act, loans from one banking subsidiary to another or to the holding company, that is, "cross-stream" and "up-stream" loans, were prohibited.) However, because the purchase of loan paper without recourse is not considered an extension of credit, it appears no significant restrictions now exist on the purchase of loan paper by one subsidiary from another or loan participation between subsidiaries."[27]

Yet, even with the elimination of the "outset" restriction, the holding company has the operating problem of arranging loan participation among affiliates, all of which are separate banks and all of which may not be wholly owned. This differs from the situation in the branch system, where any branch office may lend the legal maximum to any single customer. Consequently, the extention of large lines of credit beyond the loan limits of a single holding company unit can be arranged, in practice, more easily in the branch system. Here, however, a distinction needs to be drawn between what a branch can _legally_ do and what it actually does in practice. For instance, the idea that _any_ branch can commit the full bank line of credit requires modification to the extent that operating limits may be placed on the lending authority of branch managers.

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[27]Lawrence, _op_._cit_., p. 10.

If the lending authority of branch managers is limited, then they also require a type of "participation" from the home office for loans larger than their authorization.

Yet, one clear difference remains between the holding company and merged organization--the mobility of funds in the holding company involves the role of the directors in each affiliated bank. The legal responsibilities of these directors exists irrespective of participation agreements or the lending policies of the holding company. Where affiliates are not 100 percent owned directors have a clear responsibility to <u>all stockholders</u> in resolution of issues involving movement of funds, dividends, up and down stream loans, rates on such loans, and other matters involving the profitability of the individual bank.

Increased Financial Strength

Numerous sources cited increased financial strength as a characteristic of both forms.[28] Typically, these organizations have larger capital bases and, with few exceptions, serve more extensive marketing areas through their affiliates and branches. Larger size and more extensive market areas make it possible to have a greater variety of loans in the

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[28] Lamb, op.cit., p. 234; Hogenson, op.cit., pp. 139, 142, 144; Lawrence, op.cit., p. 6; and Federal Reserve Bank of Richmond, "The New Look in Banking Structure," Monthly Review, July 1963, p. 3.

portfolio and, thus, spread the risk over a larger operating base. As pointed out in one paper, a branch system as well as a unit bank must limit its loan-to-asset ratio, but it need not do so at any one office.

> "Its overall ratio will depend on loan demand in many areas, not just one. Some offices may have loan ratios that would be too low to be profitable for a unit bank; others may have ratios too high to be safe for a unit bank. In aggregate, the ratio may be higher than the average of a group of unit banks similarly situated because funds are more efficiently transferred from office to office in a branch system, and because the risks of illiquidity associated with deposit withdrawals are spread over a larger base and thereby reduced."[29]

Flexibility in Acquiring Capital

Today, both commercial banks and holding companies may use equity and debt financing. This was not always the case.

> "The sale of debentures by commercial banks is a relatively recent development. Before 1933, banks relied upon common stock and retained earnings for capital funds. Indeed, neither national nor state bank legislation authorized the issuance of either preferred stock or debt securities."[30]

Up until 1962, when new regulations were issued by the Comptroller of the Currency, the brief history of debenture

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[29] Horvitz and Shull, op.cit., p. 150.

[30] George W. McKinney, Jr., "New Sources of Bank Funds: Certificate of Deposit and Debt Securities," Law and Contemporary Problems, Vol. XXXII, No. 1, Winter 1967, p. 85.

financing by American banks was said to have been dominated by the adverse attitude of bank regulatory authorities at both the national and state levels.[31] The Comptroller's regulation permitted national banks to issue convertible or nonconvertible capital debentures up to 100 percent of unimpaired paid-in capital stock plus 50 percent of unimpaired surplus funds. Similar regulations permitted national banks to issue preferred stock, convertible or nonconvertible, without limitations as to capital and surplus. By June 1964, most state regulatory agencies had followed the lead of the Comptroller, and "all but fourteen states had authorized the use of debentures, and only four prohibited the use of both preferred stock and debentures."[32]

In view of these recent developments in bank debt financing, the critical question is whether the two forms have the same flexibility in acquiring capital. Here the literature suggests that both forms enjoy greater flexibility as the result of increased size, because major banks and holding companies--to a greater extent than formally--are traded on regional and national exchanges and reported by certain security dealers.[33]

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[31] Ibid, pp. 86-87.

[32] Ibid., p. 90.

[33] See: Bank Stock Quarterly, a publication of M. A. Schapiro and Company, Inc., Underwriters, brokers and dealers in bank stocks, which reports on selected commercial banks and holding companies.

One author states, "Economists who have analyzed bank holding companies have consistently concluded that the subsidiaries of bank holding companies have significant advantages over independent banks in acquiring capital."[34] Another author argues that one of the strongest reasons for the holding company as an organizational form is that the parent usually has the capacity to supply affiliated banks with additional capital as its growing volume of business requires.[35] And, one study found that a "billion dollar" holding company may sell its stock at rates often competitive with even the largest independent banks in the area, but a small group system apparently has little advantage since affiliates usually raise their own capital. However, "a small bank which is the member of a very large group system finds it possible to secure added funds via the group at a substantial saving."[36] Moreover, Fischer found small banks were able to attract large amounts of equity funds from new investors as well as from their own shareholders. He concluded that no small bank is necessarily prevented from selling stock as a result of size alone. The two reasons why small banks raise equity capital infrequently

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[34] Lawrence, _op_._cit_., p. 7. One reason is that the shares are usually traded on national or regional markets.

[35] Lamb, _op_._cit_., p. 148.

[36] Fischer, _Bank Holding Companies_, _op_._cit_., p. 124-25.

are: (1) it usually must be offered at a discount from book; and (2) owners of closely held banks do not wish to lose control of the bank.[37]

The preceding paragraphs clearly suggest that the holding company enjoys certain advantages in the acquisition of capital. As an example, the holding company can raise capital at either the parent or affiliated bank level, or both. A merged system can raise capital only at the bank level. The holding company has no restrictions on the use of debt. The merged system has limitations on debentures, and notes of less than one year maturity must be counted as a liability requiring reserves. Thus, the holding company seemingly has more _flexibility_ in raising capital. However, there is no empirical evidence which conclusively demonstrates that this results in some tangible economic benefit, such as a lower cost of capital or greater earnings per share from the use of leverage. Consequently, the flexibility advantage of the holding may be less significant than it appears. Future empirical studies comparing the "cost of capital - capital structure" relationship of comparable merged systems and holding companies may be useful in resolving this point.

Less Dependence on Outside Credit Centers

An advantage of both forms is that this type of organization may grow large and strong enough to compete effectively

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[37] _Ibid._, p. 127.

with outside credit.

> "By building groups that have substantial amounts of banking funds concentrated in the hands of compact organizations, adequate banking resources will be available at all times which will not be subject to the influences foreign to the needs of these regions."[38]

Consequently, credit inflow is reduced and the region's dependence on outside financial centers, such as New York City, is lessened. In fact, this argument was cited as justification for liberalizing Virginia's banking legislation, in 1962, in order to get larger individual banking organizations in the state.

IV. MARKETING CHARACTERISTICS

Marketing characteristics of holding companies and merged systems are broadly discussed in the literature in terms of the quantity and quality of banking services. With few exceptions big banks, whatever their form, offer a larger array of services, and service different markets and customers than do small banks. With this in mind, the critical question is: "What type of organization is better in this market of big organizations?"

The literature argues that larger banking organizations are generally more efficient than their smaller competitors,

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[38]Hogenson, op.cit., p. 144.

and these more efficient organizations typically can offer more services at a lower unit cost to their customers. Four marketing characteristics of these larger banking organizations are commonly cited: (1) uniform banking facilities and services, (2) greater range and depth of banking services, with possibly improved and (or) less costly banking services, (3) a stimulation to competition, and (4) marketing identity.

Uniform Banking Facilities and Services

The larger holding companies and merged systems both offer banking facilities and services that are uniform in the sense that each affiliate or unit has access to the same array as all of the other units throughout the system. Thus, any disparity between services available to metropolitan and rural communities tends to be eliminated. For instance, one author argued that in the holding company, "Country banks are able to receive the benefit of specialists in banking who can be maintained only by the large metropolitan banks. In this way every bank customer is assured the use of all services promptly and with little additional charge."[39] While non-affiliated country banks theoretically can and do obtain similar services through their correspondent relationships, this often does not provide the same degree of uniform "Regional Banking" that results from the larger merged system and holding company.

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[39] Hogenson, op.cit., p. 139.

Greater Range and Depth of Banking Services

Larger banking organizations typically provide a greater variety of services.

Larger Lines of Credit. It is alleged in the literature that the banking needs of the region or community are better served by the holding company and merged system because larger lines of credit are available. By having a larger line of credit these systems can better serve industry which generally has expanded more rapidly than banking.[40] For instance, small banks would find it difficult to serve the relatively few customers who benefit from large lines of credit. By way of contrast, the larger systems can serve these typically important customers in the broader regional or national markets and provide the specialized services they need. A resulting benefit is greater diversification of risk in the larger, more wide-spread banking organizations because they can commit greater proportions of potential bank credit to individual communities.[41]

More Extensive Banking Services. Centralized research and service activities of both forms frequently benefit bank customers with broadened services at the local level.

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[40] Lamb, op.cit., p. 235.

[41] Federal Reserve Bank of Richmond, "The New Look in Banking Structure," op.cit., p. 3.

> "Small unit banks are limited in the quality and selection of financial services they can offer the public whereas even the smallest group affiliate can make a great variety of specialized financial services readily available to bank customers."[42]

> "Because of the ability to centralize some functions, and because it is unnecessary to erect expensive buildings for each office, a branch system can provide full banking services in areas which could not support even a small unit bank offering limited services."[43]

Trust accounts and other specialized areas are the most commonly cited examples of the extension of banking services, and it is pointed out that smaller unit banks are rarely able to employ profitably really competent specialists. On the other hand, the large holding company or branch system ordinarily employs specialists in areas such as: (1) agriculture, (2) industrial loans, and (3) real estate. This advantage of system banking, however, obviously does not apply across the board to all customers and all markets. Certainly, there is no reason why all banks should supply every service, if for no other reason than some markets may not profitably support a full service banking operation.

More Efficient and Less Costly Banking Services. As previously concluded in this chapter, both forms generally

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[42] Lamb, op.cit., p. 235-36.

[43] Federal Reserve Bank of Richmond, "The New Look in Banking Structure," op.cit., p. 3.

benefit from "economies of scale," centralization and specialization. Because of this it is suggested they bring more efficient banking services to the public. For instance, one study suggested that communities had better banking services following the entry of holding companies; loan-to-deposit ratios were higher indicating community borrowing needs were probably being better served and the general level of interest rates did not increase.[44] In addition, a more recent study found that the changes expected in the performance of affiliates in local market areas were: (1) increased supply of bank loans, (2) increased accommodations of state and local government credit needs, (3) higher customer service charges, (4) not significantly higher time deposit interest rates, (5) no significant change in interest rates on loans; and (6) operating efficiency not changed when measured in terms of operating expenses to operating revenues.[45] For merged systems, another study concluded that the performance characteristics of unit banks and branch banks have "systematic differences". In general, after mergers the community benefited from expansion in the number of services offered by the affiliated banks and, in the case of some service functions, lower costs.

> "Interest on time deposits rose, loan rates generally fell, and loan

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[44] Fischer, Bank Holding Companies, op.cit., pp. 130-34.

[45] Lawrence, op.cit., p. 24.

> terms and lending authority were generally extended at the acquired bank. Service charges on checking accounts were generally increased at the acquired bank."[46]

While arguments and empirical evidence suggest that the public benefits from greater services and possible lower costs from the two forms, the findings are not considered absolute. A recent summary of banking research stated that branch banking and performance relationships may be due to factors other than the prevalent form of banking organization.

> "In particular, branch and unit banking follow fairly definite geographic patterns in the United States, suggesting that regional differences in demand or in the character of state banking regulations could have pronounced effects on bank performance that may not properly be attributed to organizational characteristics."[47]

Furthermore, seven recent studies agreed in only one finding--branch banks usually have higher net earnings relative to capital and higher loan to asset ratios, than unit banks in the same state.[48] Consequently, findings in the area of efficiency and profitability of unit banking vis-a-vis system banking are at best only suggestive. Furthermore, the

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[46] Horvitz and Shull, op.cit., pp. 176-77.

[47] Federal Reserve Bank of Chicago, "Competition in Banking: What is Known? What is the Evidence?", op.cit., p. 11-12.

[48] Ibid., p. 12.

comparative profitability of efficiency of one system as contrasted to the other is a question which lacks quantitative evidence of a substantial nature. Consequently, no judgment is possible on this point.

Stimulation to Competition

The argument that the expansion of both forms stimulate competition among banking institutions was not universally held in the literature. One view was that some economists, bankers, and public officials believe that branch banking is "an essentially procompetitive form of banking that facilitates the penetration of additional banking markets and brings to bear the force of potential competition on even the smallest and most isolated banking markets."[49] Additional support for this view was drawn from a comparative study of Vermont, statewide branching, with New Hampshire, unit banking, which said that statewide branching "also seems to have instigated slightly more competition, although this might be caused by other factors."[50] And the same benefits are attributed to holding company operations:

> "The public is the beneficiary of these activities, especially as they

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[49] Federal Reserve Bank of Chicago, "Competition in banking: the issues," Business Conditions, January 1967, p. 15.

[50] Federal Reserve Bank of Boston, "What Price Branching? Banking in Vermont and New Hampshire," Business Review, August 1964, p. 2.

> stimulate unit bankers in the area to improve banking services in order to maintain their positions in the market."[51]

On the other hand, the opponents of branching--whether accomplished through a holding company or by direct merger--argue that it is monopolistic and tends to restrict competition. This controversy, of course, is still an open issue. It involves many political and economic considerations in the continuing broader public debate over the question of unit versus multiple unit banking. The examination of this issue is not included in the scope of this study.

Marketing Identity

The holding company has greater flexibility in selecting its marketing identity than does the merged system. That is, for a bank which has served a community for many years--one with an outstanding reputation--the "local" name can continue to be used after affiliation with a holding company. On the other hand, where the acquiring holding company's name may be better for marketing identification, then an affiliate can take on the identity of its parent, i.e., Marine Midland. By the way of contrast, in expansion by direct merger the acquired bank, of course, takes the name of the acquiring bank, thereby losing the benefit of "local identity" in markets where this may be important.

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[51] Lamb, op.cit., p. 238.

V. LEGAL CHARACTERISTICS

The differences in the legal form of corporate organization and the consequences that flow from these differences provide one of the biggest areas of contrast. These will be discussed with regard to national and state regulation and other legal considerations relating to expansion.

Bank Holding Company Legislation

The Banking Act of 1933 was the first Federal law affecting the regulation of bank holding companies. It has historical significance because it gave explicit recognition, for the first time in Federal Banking Laws, to such institutions.[52]

> "Although the Banking Act of 1933 was not designed primarily to regulate group banking, it did contain provisions covering limited supervision over holding companies having control of banks belonging to the Federal Reserve System. Under this law a bank holding company is designated as a "holding company affiliate" and as such is required to secure a voting permit from the Board of Governors of the Federal Reserve System before it may vote stock of national or state member banks. Thus, the Board acquired new supervisory functions affecting both banks and the holding company affiliates controlling them."[53]

However, this regulation proved inadequate and the Bank Holding Company Act of 1956 was passed after 18 years of debate

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[52] Nadler and Bogen, _op.cit._, p. 11.

[53] Lamb, _op.cit._, p. 215.

concerning Federal jurisdiction over the operation of bank holding companies.[54]

Passage of the (Bank Holding Company) Act of 1956 established a new era for the development of the bank holding company. It recognized this form of organization as an integral component of American commercial banking.[55] Generally, the Bank Holding Company Act of 1956 accomplished three objectives: "(1) to define a bank holding company in terms that cover all such companies which need to be regulated, (2) to control their expansion within limits that promote the public interest, and (3) to require divestment of non-banking interests in order to avoid certain hazards that could accompany mixed ownership."[56] The bank holding company was defined under Section 2(a) of the Act as a company:

> (1)"That directly or indirectly owns, controls, or holds with power to vote 25 per centum or more of the voting shares of each of two or more banks or of a company that is or becomes a bank holding company by virtue of this Act, or
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> (2) that controls in any manner the election of a majority of the directors of each of two or more banks; and for the purpose of this Act, any

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[54] Ibid.

[55] Ibid., pp. 199-200. Forty-two separate holding companies were registered with the Board of Governors on December 31, 1960.

[56] Ibid., p. 215.

> successor to any such company shall be deemed to be a bank holding company from the date as of which such predecessor company became a bank holding company."

The other provisions of the 1956 Act pertinent to this dissertation relate to expansion. The Act requires prior approval of the Federal Reserve Board for any holding company formation or expansion. Approval is based on the following factors as specified in Section 3(c) and (d) of the Act:

> (c) The Board shall not approve--(1) any acquisition or merger or consolidation under this section which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize the business of banking in any part of the United States, or (2) any other proposed acquisition or merger or consolidation under this section whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly out-weighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.
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> In every case, the Board shall take into consideration the financial and managerial sources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served.
>
> (d) Notwithstanding any other provision of this section, no application shall be approved under this section which will permit any bank holding company or any subsidiary thereof to acquire, directly or indirectly, any voting shares of,

> interest in, or all or substantially all of the assets of any additional bank located outside of the State in which the operations of such bank holding company's banking subsidiaries were principally conducted on the effective date of this amendment or the date on which such company became a bank holding company, whichever is later, unless the acquisition of such shares or assets of a State bank by an out-of-state bank holding company is specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication. For the purposes of this section, the State in which the operations of a bank holding company's subsidiaries are principally conducted is that State in which total deposits of all such banking subsidiaries are largest."

The passage of the 1956 Act, in addition to accomplishing the three objectives identified on Page V-31, gave bank holding companies a "respectability" they lacked in the minds of many persons both in and out of the banking business. The Act removed many of the ambiguities that had made this form of banking somewhat unclear, i.e., it removed the fear that a highly restrictive federal law would be passed by Congress as the result of the hearings then being devoted to bank holding company legislation. In fact, this fear of restrictive federal legislation was identitied as one cause for the great expansion of holding companies in the period just before the Act.[57]

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[57]Fishcer, American Banking Structure, op.cit., p. 98.

The Bank Merger Act of 1960

Before enactment of the Bank Merger Act, Federal statutes contained relatively few guidelines regulating expansion of commercial banks by merger. The 1960 Act tightened control. It provided for direct administration by the banking authorities and established broad public interest standards to guide the administration of controls.[58] Expansion by merger was put under the supervision of the Comptroller of the Currency, or the Federal Deposit Insurance Corporation or the Federal Reserve Board, depending on the legal status of the surviving bank.[59] In broad policy regarding expansion the Bank Merger Act of 1960 followed the direction of the Bank Holding Company Act, although it incorporated slightly different legal and administrative standards.[60] These differences

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[58] The United States Treasury, "Appendix: The Banking Structure in Evolution" Studies in Banking Competition and the Banking Structure, January 1966, p. 407.

[59] a) The Comptroller of the Currency has authority over merger applications if the acquiring, assuming or resulting bank is to be a national bank or District bank; b) the FDIC has authority over merger applications if the acquiring, assuming, or resulting bank is to be a nonmember insured bank, except a District Bank; and c) The Board of Governors of the Federal Reserve System has authority over mergers if the acquiring, assuming, or resulting bank is to be a State member bank, except a District Bank.

[60] George R. Hall and Charles F. Phillips, Jr., Bank Mergers and The Regulatory Agencies (Washington, D. C.: Board of Governors of the Federal Reserve System, 1964.) This is a recent study analyzing current policies as related to the merger decisions by the three Federal bank supervisory agencies.

were eliminated in the 1966 amendments to the Acts. Similar requirements are now considered in the approval of merger or holding company acquisition applications.

The Department of Justice has recently become active in the regulation of bank expansion by way of anti-trust. However, its interest in maintaining competition is not germane to this discussion of the relative advantages of merger versus holding company expansion.

Differences Between Direct Merger and Holding Company Expansion Stemming from National Regulation

Several differences in national legislation seem to favor the merged form. While the literature gave scant attention to this area, one recent thesis suggested that advantages to using the merged form of expansion are: (1) greater probability of approval of merger applications, (2) shorter time for approval, and (3) less cumbersome procedural processing.[61]

Greater Probability of Approval of Merger Applications. Based on an examination of past Federal Reserve Board decisions one study concluded that:

> "The Board rules more harshly against holding companies than mergers... From

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[61] Flinn, *op.cit.*, pp. 49-68.

> 1961 through 1966 the Federal Reserve Board approved 79 bank holding company formation applications and denied 20, for a record of four to one. During the same period the Board approved 157 mergers and denied 15, for a record of 10 to 1."[62]

Application Approval Time. During 1963-1964 the same study reported that holding company applications took considerably longer to process than merger applications. The average time was 7.4 months for the holding company and 3.2 months for merger.[63] The impact of a processing delay was illustrated by a case concerning Virginia Commonwealth Corporation. Here an acquisition offer seemingly was not acceptable to the stockholders of the bank being acquired because the market price of the holding company's shares fell during 5.5 months of processing by the Board.[64]

Procedural Differences. Several major procedural differences in the processing of applications are said to favor the merger route.[65] The differences apply to public disclosure--also applicable to mergers where the Federal Reserve Board is the governing agency--and the possibility of hearings and resultant delays if the Comptroller of the Currency or the

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[62] Ibid.,p. 53.

[63] Ibid., pp. 54-55. It was noted that recent decisions were being processed "with somewhat greater dispatch."

[64] Ibid., p. 55

[65] Ibid., pp. 58-60.

appropriate state agency disapproves the application within 30 days. Also, minor differences in application processing are said to make holding company application more cumbersome to prepare.

> "It should be sufficient to note that the holding company applications are more cumbersome in that the Board requires information for each affiliated bank and not just for the system as a whole. In addition data on correspondent bank balances, consumer loans purchased, and municipal securities is called for. This information is not required by the merger forms."[66]

<u>Differences Between Direct Merger and Holding Company Expansion Stemming from State Legislation</u>

The Virginia state banking code regulates the expansion of individual banks. As discussed in Chapter III, *de novo* branches are restricted to the immediate area of an existing bank, while mergers are authorized on a statewide basis. As the result of this, a bank merging into another community cannot branch *de novo* in the area of the bank it merged.[67] By way of contrast, holding company expansion is not regulated under the banking code. A holding company may acquire a bank

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[66] *Ibid.*, p. 60.

[67] A merged system could merge with a bank in another community which already has its own branches, and thus obtain multiple banking locations in the new area. However, further *de novo* branches would not be authorized.

of contrast, in expansion by holding company the acquired bank retains its own board and bank officers because it remains a separate corporate entity.

On one side, holding company proponents argue that retention of the acquired bank's board keeps control of the bank at the local level, in the hands of people who are familiar with the problems and needs of the community. As one author said, "No bank holding company can exert a veto power over actions of the board of directors of bank subsidiaries",[69] although this statement appears to be of dubious validity because of the various voting control situations that can exist for holding company affiliates. Thus, the legal status of affiliate directors is thought to be the essence of decentralized management in a holding company.

> "Though they may delegate to their officers the day-to-day routine of conducting the bank's business, they cannot delegate the consequences resulting from unsound practices and policies for which they are both criminally and civilly liable."[70]

On the other side, the proponents of direct merger argue that a single board and group of officers simplifies the corporate structure and facilitates management control.

These contrasting views ascribing to the virtues of centralized versus decentralized control are a question which

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[69] Nadler and Bogen, op.cit., p. 22.

[70] Flinn, op.cit., p. 79.

is not and cannot be clearly resolved in the favor of either form. However, this is not thought to be the only issue regarding directors. A question remains unanswered: "Are honorary boards effective substitutes for the legal boards they replaced and, if not, what are the consequences?"

<u>Impact of Differences in Reserve Ratios on System Deposits</u>. There may be differences in earnings potential between a merged system and a holding company because of differences in the reserve ratios applied to deposits throughout the system.[71] Ratios in the period of this study used for illustration of this point were 10 percent for state non-members, 12 percent for non-reserve city members, and 16 1/2 percent for reserve city members.

For a merged system the location and classification of the bank sets the reserve ratio against deposits for the whole system. For example, a merged system in Richmond--a reserve city--applies the 16 1/2 percent ratio against systems deposits, while a merged system in any other Virginia locality applies 12 percent, so long as it does not have a branch in Richmond. A holding company with a Richmond affiliate applies the 16 1/2 percent ratio only to that bank, and the 12 percent ratio to all affiliates outside of Richmond. Additionally, a holding

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[71] <u>Ibid</u>., pp. 93-95.

company benefits from the 10 percent ratio for non-member affiliates, thus further lowering the effective ratio applied against all deposits in the system.

From this discussion it is clear that there are differences in earnings potential on demand deposits for statewide banking systems depending on the type of system, the location and the member status of the system. The impact of these differences generally favors the holding company over the merged system. However, changes in reserve ratios can and do take place. Consequently, the foregoing discussion is valid only as it applies to the situation reported. The ratios could change at any time.

Entry Into a Reserve City. A major system operating in Virginia with a home office outside of Richmond--a reserve city--has an advantage in seeking entry into Richmond if the expansion is done by holding company. For instance, a merger with a Richmond bank by Virginia National, home office in Norfolk, would require the greater Reserve City ratio be applied against their total system deposits. Thus, the potential earning power of these incremental deposits are lost and the profitability of the system as a whole is adversely effected. A holding company acquisition in Richmond, however, would not affect the reserve position of other system affiliates as they are considered individual banks subject to the reserve requirement applicable to their own areas. As a result holding company

entry into Richmond is less costly and, therefore, more attractive than merger.[72]

Procedural Implementation of Mergers and Holding Company Affiliation. A recent study, contrasting two methods of expansion in Virginia, concluded that holding company expansion is more flexible from a procedural standpoint.[73] A holding company can expand by one of four methods: (1) acquisition of an affiliate through an exchange of stock, (2) acquisition by "the phantom bank technique", (3) acquisition of a *de novo* branch, and (4) merger of an existing bank into one of the holding company's affiliated banks. By the way of contrast, a merged system can expand, outside of its own area, only by merger.

A useful feature of bank mergers in Virginia is that there is no minority interest. Under Virginia law a vote for merger by two-thirds of the stock of the merging bank--if it is a state chartered bank--forces the exchange of the remaining stock.

> "While under federal statutes (12 USC 215 and 215a) dissenting stockholders of the merging bank have the right to an

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[72] This situation would apply to other states if they had similar legislation regulating expansion, and a Reserve City Bank.

[73] Flinn, *op.cit.*, pp. 60-67.

> appraisal of the value of their shares and to receive cash payment, therefor, the Virginia Statutes (Article 5 Section 13.1-68 et.seq. of the Virginia Stock Corporation Act) contain no such provision."[74]

By way of contrast, acquisition by holding company through an exchange of stock generally results in less than a 100 percent ownership of the acquired bank.[75] However, to obtain 100 percent ownership in a holding company acquisition the "phantom bank" technique can be used. Under this technique the new bank may retain the name and charter of the merging bank, so that it would appear the merging bank survived.

> "This technique uses a shell corporation, the phantom, a minimumly [sic] capitalized corporation bearing a bank name, into which the bank to be acquired is merged. With an affirmative vote by holders of two-thirds of the bank's stock the remaining one-third is forced to accept the exchange (and dissenting stockholder, where applicable, to accept cash). Then in a three-way exchange--the phantom through merger receives the bank's stock, the

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[74] *Ibid.*, p. 61.

[75] Under Internal Revenue Service regulations eighty percent is needed to make the exchange on a tax-free basis. However, conditions for exchange of a minimum percentage of the shares of the bank to be acquired can be set. For example, in the exchange offer by United Virginia Bankshares dated December 13, 1962 to Citizens Marine Jefferson Bank, Trust and Savings Bank of Lynchburg, Merchants and Farmers and the Vienna Trust Company, 50 percent of the shares was used as a minimum percentage. In this case the holding company wanted majority control and not a minority position.

> phantom (now a bank) issues its stock to the holding company, and the holding company issues its stock to the bank's shareholders--the holding company acquired 100 percent ownership."[76]

IV. SUMMARY

This chapter has identified the advantages and disadvantages of the two forms of organization as drawn from the literature. They are now summarized in Table V-I in the form of a "Factor Sheet" of advantages of one form relative to the other:

TABLE V-I

FACTOR SHEET OF LITERATURE BASED ADVANTAGES AND DISADVANTAGES OF DIRECT MERGER AND HOLDING COMPANY EXPANSION

Advantages of Holding Company--Relative to a Merged System

Operational and Organizational

1. Organizational flexibility
2. Wider range of options for management control
3. Local Autonomy

Financial

1. Greater flexibility in acquisition of capital

(continued)

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[76]Flinn, *op.cit.*, pp. 63-64.

TABLE V-I (continued)

Marketing

1. Affiliated banks retain local identity in their market area

Legal

1. Greater branching opportunities in Virginia
2. Reserve ratio advantages
3. Can select easiest route for approval of expansion
4. Retain local control through the board of directors and bank officers at the affiliate level

Advantages of Merged Systems--Relative to a Holding Company

Operational and Organizational

1. Organizational uniformity and simplicity
2. Closer control of policy and operations
3. Greater cost benefits from integration of operations

Financial

1. Greater credit mobility

Marketing

1. Greater opportunity for uniform facilities and services
2. Single corporate identity

Legal

1. Generally has required less time for approval of expansion applications
2. "Track record" for approval of merger applications has been better than for holding company applications.

Apparent Weaknesses in the Literature

In important areas there seems to be lack of empirical data directly comparing the two forms. Consequently, it was not possible to draw from the literature conclusions that one

form benefits more than the other with regard to economies of scale, efficiencies from integration, or "cost of capital - capital structure relationships".

Also, numerous alleged advantages and disadvantages were commonly treated only in generalities. These did not appear to consider the points-of view of various parties having an interest in expansion, such as stockholders, management, lenders, borrowers, or regulatory authorities; nor did they consider various policies, such as management's attitudes toward growth, competition, or organizational control. Consequently, it was difficult if not impossible to assess adequately the relative merits of these generalizations. The contrasting views on "centralization vis-a-vis decentralization" were a case in point.

Lastly, the literature did not illustrate or suggest a method or approach whereby management could assess the significance of the various advantages and disadvantages in selecting between the two forms; particularly in a specific situation. This deficiency appeared to stem, in part, from the lack of an examination of the advantages and disadvantages from various points-of-view, or from analysis of considerations that might be determining in different kinds of situations. Examination of the expansion experiences of the two systems studied will attempt to suggest how assessments of significance can be made by consideration of various points-of-view and policies.

CHAPTER VI

THE EXPANSION DECISIONS: BACKGROUND

This chapter addresses itself to the background events concerning the decisions of First and Merchants and Bankshares to select forms of expansion. Three salient points are important to this discussion: (1) managements of both organizations had been interested in changing the restrictive branching legislation passed in 1948, (2) both had been sponsors of the Virginia Metropolitan Plan, a proposal to liberalize branching, and (3) after introduction of the Buck-Holland Bill both had the option to select either form of expansion.

Prior to passage of the Buck-Holland Bill, in 1962, First and Merchants and State-Planters--the lead bank in Bankshares--had been among a group of large Richmond banks actively sponsoring a change to the restrictive 1948 branching legislation. Together these banks attempted to gather support throughout the state for the Virginia Metropolitan Plan, a branching scheme to allow merger between banks in metropolitan areas. The sponsors wanted this plan to be adopted by the Virginia Bankers Association at their June 1961 convention. Had this been done, the intent of the Virginia Bankers Association was to propose the plan as an amendment to the state banking codes for recommendation to the 1962 General Assembly; the plan,

however, failed. Consequently, First and Merchants' and State-Planters' managements felt any liberalization of the branching laws had been delayed for at least another two years, until the next biannual meeting of the General Assembly in 1964. However, the subsequent surprise introduction of the Buck-Holland Bill, in early 1962, permitted both banks to reconsider their expansion plans, in light of the fact that expansion would be possible by direct merger as well as the holding company route.

I. FIRST AND MERCHANTS ELECTED TO EXPAND BY DIRECT MERGER

After the Virginia Metropolitan Plan failed management at First and Merchants considered expansion by the holding company route. In explaining the chronology of events, a First and Merchants officer said:

> "We were actively studying the formation of a holding company and had retained the services of experts in the field. Our planning for a holding company had moved right along, but we feel fortunate, from our standpoint, that the Buck-Holland legislation got into the mill in time for us to take advantage of it. That is to say, we had not gone so far that we could not scrap our plans for a holding company, and embark on a program for expansion by merger, as authorized under the 1962 legislation.
>
> On this same subject, we believe (we do not know) that if some of the others had not gone so far with their commitments for the holding company form, they would have changed their

> plans, also. But, we feel some had gone so far that they just could not back up and they had to go ahead with their commitments."[1]

If it is assumed that direct merger is a "better method" of expansion, passage of the Buck-Holland Bill was an unexpected advantage to First and Merchants. That is to say, if First and Merchants' competitors had gone so far with holding company plans that they could not reconsider, then they did not have an opportunity to choose the "better method." However, if First and Merchants was late in formulating expansion plans by way of the holding company route, then this fortunately worked to their advantage because it resulted in its not being committed to a less desirable form of expansion at the time the Buck-Holland Bill opened the merger route.

II. BANKSHARES ELECTED TO EXPAND BY THE HOLDING COMPANY ROUTE

As was the case with First and Merchants, State-Planters started to investigate the feasibility of forming a holding company after the Virginia Metropolitan Plan failed.[2] However,

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[1]Cf. Appendix (C), p. C-3.

[2]As early as 1958 the president of State-Planters, then Mr. J. Harvie Wilkinson, Jr., had considered the concept of formation of a holding company with other large Virginia banks. This was seen as a move which would improve the competitive position of the banks concerned, regardless of any subsequent action by the state legislators to relax the highly restrictive 1948 branching laws. However, this initial plan for a holding company never got beyond the conceptual state. Cf. Appendix (A), p. A-3-4.

no action resulted from these efforts until, unexpectedly, in the latter part of 1961, First and Citizens National Bank of Alexandria approached State-Planters with a proposal. By early 1962 four other banks had joined together to form the initial Bankshares group, which commenced operations as a six bank holding company in January, 1963.[3] In explaining the chronology of events, a Bankshares officer said:

> "We knew of the Buck-Holland legislation before we filed with the Securities Exchange Commission to form United Virginia Bankshares in June, 1962. Therefore, we had the opportunity to drop it and go the merger route if we wanted. But all of the parties had been sold on, and they liked the idea of forming a holding company where everybody would have something to say; we were building something together; all parties were participants. The local autonomy aspect was important, too. No proposal was made to try to force through the merger route. The feeling was just so strong that this was what we wanted to do that this is the way we went."[4]

The original members of Bankshares had the opportunity to change their holding company plans and expand by direct merger under the Buck-Holland legislation, which became effective July 1, 1962. The foregoing quote indicates that

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[3] Cf. Appendix (A), Table A-I, United Virginia Bankshares List of Acquisitions and Affiliate mergers.

[4] Cf. Appendix (A), pp. A-3-4.

management was not "locked into" the holding company form of expansion, even though plans were well along in the final stages. Furthermore, while it is clear that expansion by holding company was the preferred route for the Bankshares group and that a participating management philosophy was an essential factor in this decision, it is assumed that had there been sufficient evidence to indicate direct merger was clearly the better route, then this path might have been chosen. Consequently, Bankshares' management decision to expand involved an explicit choice of alternative expansion methods--holding company versus direct merger--as was the case with First and Merchants.

III. THE MANAGEMENT DECISIONS

The primary reasons why each of the managements chose their respective form of expansion and the key elements of their expansion strategy are summarized at the end of this chapter, in Tables VI-I through VI-IV. The examination of each of these topics follows in the next four chapters. These chapters discuss why both managements considered one form of expansion preferable to the other, and with reference to the literature, will attempt to evaluate the various considerations as guides for management action. The four functional areas previously used in development of the literature framework are each the subject of one chapter: (1) operational and organizational, (2) financial, (3) marketing, and (4) legal considerations.

TABLE VI-I

FACTORS CONSIDERED BY FIRST AND MERCHANTS TO BE ADVANTAGES AND DISADVANTAGES OF EXPANSION BY DIRECT MERGER

The merged form was preferable to the holding company because it provided or permitted:

1. A basis for better organizational control than does the holding company form.
2. A better solution to the problem of management succession.
3. Greater mobility of funds.
4. Greater diversification of risk.
5. Increased lines of credit to a single customer.
6. Greater financial flexibility.
7. Larger individual banking units which are better able to attract industry to Virginia's growing industrial communities.
8. Greater community services.
9. Economies in operation.

The merged form was seen to have these disadvantages as contrasted to the holding company:

1. Loss of the merged bank's name.
2. Change in the status of the merged bank's board of directors
3. De Novo branching restrictions in the area of the merged bank.

NOTE: The ordering of these factors does not indicate priority.

Data from Appendix (C).

TABLE VI-II

FACTORS CONSIDERED BY BANKSHARES TO BE ADVANTAGES AND DISADVANTAGES OF EXPANSION BY HOLDING COMPANY

The holding company form was preferable to the merged form because it provided or permitted:

1. Greater de novo branching opportunities.
2. Efficiency equal to the merged form.
3. Flexibility in raising capital.
4. Greater flexibility in expansion.
5. Local autonomy for affiliates.
6. Local identity for affiliates.
7. Decentralized decision-making which offers more management flexibility and opportunity.
8. Non-member (Federal Reserve System) banks retain their lower 10 percent state reserve requirements when they become holding company affiliates; and only holding company affiliates (members of Federal Reserve System) in reserve cities are required to use the 16 1/2 percent reserve ratio; other affiliates to use 12 percent.

Both forms were preferable to an individual bank in Virginia because they provided or permitted:

1. Increased organization size to attract and train management personnel.
2. A solution to a management succession problem.
3. Economic benefits to the acquired bank stockholders.
4. Greater credit and funds mobility.
5. New services.

The holding company form was seen to have these disadvantages as contrasted to the merged form:

1. Complications because of Securities Exchange Regulations.
2. A more complex organization.
3. Complications from regulations by more than one agency.
4. Lack of a single corporate image.

NOTE: The ordering of these factors does not indicate priority.

Data from Appendix (A).

TABLE VI-III

KEY FACTORS IN FIRST AND MERCHANTS' EXPANSION STRATEGY

1. Merge only into areas where the growth rate will keep pace with or exceed the system as a whole.

2. Avoid dilution of book value and earnings, but give "fair value".

3. Keep strategy flexible because future mergers may be difficult due to increasing competition for the remaining banks and because of the attitude of the regulatory agencies.

4. Offset *de novo* branching restrictions in the area of the merged bank by acquiring banks which already have branch offices.

5. Offset the loss of the merged bank's board of directors by appointing an Area Advisory Board.

NOTE: Data from Appendix (C).

TABLE VI-IV

KEY FACTORS IN BANKSHARES' EXPANSION STRATEGY

1. Expand in growth areas, with emphasis on the Virginia urban corridor from Washington, D. C. south to Richmond and east through Williamsburg, Newport News, and Norfolk.

2. Acquire a leading bank in an area, if possible a bank with deposits over $10 million.

3. Emphasize local autonomy and a decentralized management philosophy.

4. Deal directly with and through management and not the shareholders of prospective affiliates.

NOTE: Data from Appendix (A).

CHAPTER VII

THE EXPANSION DECISION: OPERATIONAL AND ORGANIZATIONAL CONSIDERATIONS

This chapter deals with three operational and organizational considerations thought to be significant by First and Merchants and Bankshares in their selection of a form of expansion. These considerations are: (1) management effectiveness, (2) management succession, and (3) the efficiency of the organizational form.

I. MANAGEMENT EFFECTIVENESS

The critical issue regarding management effectiveness concerned the question: "Does a particular form of corporate organization lead to or result in more effective management?" This question was answered in the affirmative by both First and Merchants and Bankshares, even though the two banks chose different forms of organization. Their arguments centered on points involving organization theory--centralization versus decentralization, and local autonomy versus a more directive form of management control.

The Position of First and Merchants

Management Control is Superior in the Merged Form.[1] First and Merchants' management preferred the less complex

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[1] Cf. Appendix (C), pp. C-4-5.

corporate structure of the merged form because they thought it provided a basis for better control. Management believed there was less potential for the development of problems in policy formulation and execution since the merged form had a single policy group, the board of directors, and one group of senior management to execute policy. Consequently, the position of First and Merchants was that coordination to achieve unity of purpose could be attained more readily in the merged form.

By the way of contrast, First and Merchants' management thought that the unity necessary to operate a large banking organization effectively was harder to achieve in a holding company. This was because a holding company was comprised of a number of separate banks, each with its own board of directors and senior management, who were legally responsible for the soundness of policy and operations. Thus, the position of First and Merchants was that there was greater potential in the holding company for problems in policy formulation and direction. Policies could vary in accordance with the management philosophy of the individual groups.

Another aspect of control cited by First and Merchants was that one group of senior management carrying out the policies of a single board tends to reduce the time and effort required of management at the local level on policy matters.

Local management, therefore, has more time to devote to business development and service to the customer.

The Position of Bankshares

The Holding Company Form Permits Local Autonomy.[2] Bankshares preferred the holding company form because it provided local autonomy to the management of acquired affiliates. Thus, this form was a suitable framework for implementation of Bankshares' management philosophy, which was based on the holding company organization being a participating enterprise. Each of the six original affiliates was represented on Bankshares' board of directors. New affiliates were not necessarily represented. However, a committee of presidents was planned for establishment of certain policies.

> "We try to get together at least once a month with the presidents committee and talk about problems, policies, and new services that Bankshares should provide. Thus, we have a joint effort: (1) to become a statewide organization, (2) to build a larger organization to make bigger loans to Virginia businesses, (3) to extend new services throughout the system, and (4) by pooling resources to provide special services, such as in the computer area, of a quality no one bank could afford."[3]

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[2] Cf. Appendix (A), pp. A-11-12.

[3] *Ibid*.

Local autonomy and a participating management philosophy were believed by Bankshares' management to be important factors in attracting new affiliates. Even so, they found that it was hard to convince some bankers who were interested in joining a holding company that what they said about their method of operation was true. Some bankers had heard discouraging reports from those who joined other holding companies.

Local Autonomy was an Element of Bankshares' Expansion Strategy.[4] Local autonomy stemming from Bankshares' cooperative management philosophy was believed to be very helpful in attracting additional partners to the organization. For instance, an officer of Bankshares felt that local autonomy was particularly important to the executive operating a well-managed, profitable bank; this type of executive was generally thought to be a strong individual who did not want to give up any measure of operating responsibility.

Banks interested in joining Bankshares were told that the holding company retained central direction in changes in top management--the top two--and their salaries, and purchase of fixed assets or leasing new offices. Affiliates were authorized to spend up to their depreciation for new assets,

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[4]Ibid., pp. A-27-28.

but anything more required approval by the holding company. In this way real estate and purchases of major assets throughout the system were coordinated. For instance, $12.5 million had been raised during the years 1962-1966 to meet affiliates' plans for expansion. Also, dividend policy and matters which could result in a conflict of interest were other areas where the holding company retained central direction.

Flexibility and Opportunity from Decentralization in the Holding Company Form.[5] Bankshares' position was that the decentralized nature of the holding company form offered greater flexibility and opportunities for management than the typical branch system. This aspect of holding company operations was stressed because it was thought to be inherently more attractive to management personnel--it offered a better environment for developing successor management talent within the industry. Thus, it was the opinion of an officer of Bankshares that the holding company appeared to provide the better solution to the problem of successor management.

Bankshares' position was that the critical aspect of its decentralized management concept was the legal status of each affiliate's board of directors.[6] Individual affiliate

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[5] Ibid., p. A-14.

[6] "Legal status" of the board of directors has reference to the responsibilities of bank directors specified in banking statutes. Article 6, Section 6.1-45 of the Laws of Virginia

boards were thought to be a very real force in promoting and maintaining decentralization of management.

The Holding Company Form: A More Complex Corporate Organization.[7] Bankshares' management saw local autonomy as an advantage of the holding company, but at the same time they also recognized that the merged form had a simple corporate structure, one board of directors and one senior group of management. An officer of Bankshares' said that the less complex structure of the merged system simplified policy formulation and execution. Problems more easily avoided in the merged form were thought to be: (1) diffused authority, (2) internal conflict at the management level, and (3) administrative complications, i.e., separate records for each affiliate.

But, Bankshares' position was that these problems could be overcome since the holding company form provided substantially the same range of management control options as a merged system. Furthermore, management believed that the administrative problems of the more complex corporate organization of the holding company were compensated for by other advantages.

Relating to Banking and Finance states, "The affairs of every bank or banking institution incorporated under the laws of this state shall be managed by a board of directors which shall consist of not less than five persons."

[7]Cf. Appendix (A), p. A-21.

Discussion

The positions of First and Merchants and Bankshares suggest that there is a direct and important relationship between the form of corporate organization and the effectiveness of management. However, when their views are examined it is clear that, like much of the literature, they do not and cannot settle the question whether a centralized or decentralized organization and control is more effective. These views involve questions of organization theory and the role of the formal and informal organization. They involve attitudes and opinions of management. Consequently, it is difficult to resolve this question clearly in the favor of either form.

Perhaps the answer is that one form is better, or worse, for a particular group depending on the general point-of-view of that group. In this context, the positions of both parties generate several points which have implications in the selection of an organizational form for expansion.

A Particular Style or Form of Management Does Not Follow From a Particular Form of Corporate Organization. Clearly, different methods of organizing and managing banking organizations can be employed, irrespective of their corporate form. That is to say, both merged systems and holding companies may be either highly centralized or highly decentralized. Therefore, differences in organization structure and

management control seemingly are a function of the attitudes of individual managements, and depend, in part, on the circumstances peculiar to the individual situation.

The Question of "Internal Conflict--Type of Corporate Organization". Both managements admit that there is greater potential for administrative conflict in the holding company form. Their positions seemingly are related to voting control and the role of the directors in holding company affiliates. In this dissertation it is argued that control in the holding company is, in fact, less absolute; that affiliate management has more autonomy than lower level management in a merged system. This is a result of the legal responsibilities of affiliate directors, and of the different voting control situations which may exist in a holding company affiliate--a holding company may have 100 percent voting control of an affiliate, or some lesser degree of control.

A. Voting Control in Holding Company Affiliates. Generally, four different voting control situations exist in a holding company, whereas only one exists in the merged system. A holding company may have complete control, 100 percent; very large control, say 80-99 percent; bare majority control, say 51 percent; and "minority" control, say 35-49 percent. The implication for affiliate directors is different in each of these situations. Directors are responsible to all stockholders,

minority as well as majority and they have to think about different things in each case. For instance, questions of policy, such as dividends, may have different meaning to the holding company as a shareholder and to the individual investor as a shareholder. Individuals may desire a high dividend payout for income, whereas the holding company may desire a low payout for capital growth and expansion. Also, different kinds of capital expenditures--for example, purchase of real estate--may be viewed differently by a group of persons who are individual stockholders, and by a single stockholder, the holding company. Clearly, the resolution of such policy issues will probably depend on the voting control situation in each affiliate.

In cases where the holding company votes all or almost all of the shares of the affiliate, policy conflict is probably no more of a control problem than in the merged form, i.e., equivalent "power to remove and replace" rests with the parent.[8] In practice, however, the holding company does not have the same control in the resolution of problems in the other three voting control situations. Management has to accommodate satisfactorily the minority interest, no matter how small, and this

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[8]As reported in the 1967 Annual Report, Bankshares owns 96.4 percent or more of each of its affiliates and two of nine are owned 100 percent.

is a complication with which management in the merged system does not deal. Furthermore, the holding company has the recurring problem of replacing directors at the affiliate level. There is no guarantee that the views of new directors with regard to policy will conform to the old. This is another problem that does not arise in the merged organization.

B. <u>The Role of the Directors in Holding Company Affiliates</u>. An important difference between the two forms is the possibility of many boards of directors in a holding company vis-a-vis one in a merged system. This possibility has distinct control implications; for example, the comment that "no bank holding company can exert a veto power over actions of the board of directors of bank subsidiaries" takes on specific meaning.[9]

The chief officer of one large Virginia holding company described control as more of a "sell" rather than a "tell" proposition; whereas in the merged system control may be much more direct. He illustrated this difference in the case where the affiliate board will not relieve an ineffective president of his duties. Assuming the holding company has voting control, a meeting of its stockholders could be called to vote in new affiliate directors who would discharge the president. But

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[9] Nadler and Bogen, <u>op</u>. <u>cit</u>., p. 22.

this would be an unusual step. It probably would cause other problems in the areas of community relations, or business development because the "fired" directors might be influential leaders in the community. By way of contrast, similar problems could exist in the removal of a branch manager in a merged system, but the potential consequences would probably not be as severe as with the holding company where both the president and the board of directors are involved. For this reason, it was the opinion of the aforementioned chief officer that the holding company may have to "live with" poor management longer than the merged form. Consequently, not only is control of management at the affiliate level less directive, but the time required to obtain the desired response may be commensurately longer.

From Bankshares' point-of-view, autonomy of management at the local level is a highly persuasive and appealing environment for the type of manager who wants to be fully responsible for his own organization. However, this argument is loaded with implicit assumptions concerning executive motivation and performance which are not and cannot be answered here. On the other hand, several points regarding Bankshares' implementation of this concept are significant: (1) six original affiliates were represented on Bankshares' board of directors, (2) new affiliates were not necessarily represented; however (3) a committee of presidents was planned for establishment of certain policies.

This pattern of action establishes the "character" of local autonomy in the Bankshares organization, particularly for those initial affiliate officers who are also members of the holding company board. In this case, the concept of local autonomy for these affiliates is preserved so long as the "original actors" are serving in their respective roles.

However, "control" of successor generations of affiliate management probably may be more simply accomplished than in the case of the "original actors". New presidents and directors will come from <u>within</u> an already established organization. Consequently, the successor generations of management will tend to be more "organization oriented" rather than "unit bank oriented," as were their predecessors. And, as a result of this, differences in control between the two forms will tend to narrow, but not disappear over time.

<u>Business Development and Service to the Customer at the Local Level</u>. Clearly, it is difficult to draw generalizations regarding the time one form or the other provides local level management to devote to operations versus policy. The amount of time management can devote to business development and customer service at the local level in both forms seemingly depends on the range and depth of services from the parent organization, and the type of control exercised by the parent. A holding company--for example, with a high degree of centralized

management control and a large service organization--probably can provide management at the affiliate level with as much time to devote to business development and customer service as a merged system--for example, with a high degree of decentralized control and large branches which are full service organizations.

II. MANAGEMENT SUCCESSION

Both Bankshares and First and Merchants contended that their respective forms of organization improve their ability to compete for and retain management talent and to solve the problem of management succession. Bankshares' position was that this benefit was shared by both forms, as the result of increased organization size. On the other hand, First and Merchants' position was that direct merger benefits more than the holding company.

The Position of First and Merchants

Merger Provides a Better Solution to the Problem of Management Succession.[10] Three reasons were given by First and Merchants why merger provided a better solution to the problem of management succession: (1) fewer numbers of management personnel are needed at the policy development and

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[10] Cf. Appendix (C), pp. C-5-8.

operating levels, (2) larger individual banking institutions are in a better position to attract and hold young management talent, and (3) flexibility in movement of management personnel is greater.

A. Fewer Management Personnel are Required in the Merged Form. First and Merchants preferred the merged form because only one organization was involved in expansion. Their position was that fewer numbers of management personnel were required at the policy development and operating level, whereas each holding company affiliate had a continuing need for management at all levels, as long as they remained individual banks. Consequently, an officer of First and Merchants expressed the opinion that merger tended to make more effective allocation of management resources.

B. The Merged Form has Larger Individual Institutions. First and Merchants preferred expansion by direct merger because it resulted in larger individual banking units which were thought to be more attractive to the younger person because of greater opportunities, salaries and responsibilities. Furthermore, the experience in First and Merchants indicated management personnel in larger organizations typically were more willing to accept assignments in the less desirable locations because such assignments were viewed as a training ground or stepping-stone to bigger things; it was not a life-time job.

The importance of this point was illustrated by the statement made to an officer of First and Merchants by the Chief Officer of an independent bank in an outlying area:

> "How can I conceivably attract anybody to come here and live? As far as profits of the banks are concerned and because of lack of loan demand it is difficult to pay a beginning salary to attract good young management. And, furthermore, what is really available here in the community to attract permanent management? There is nothing here, except what has existed back through the century. Young qualified and educated people are interested in going where they can grow and where they do not have a definite ceiling placed on their abilities. They do not want to come here."[11]

Flexibility in Movement of Management in the Merged Form is Greater. First and Merchants preferred the merged form because it was thought to have greater flexibility in the movement of management personnel. Transfer was a matter internal to one organization in the eyes of the personnel committee, the president, and the board of directors. By way of contrast, a transfer in a holding company was seen by First and Merchants as having the possibility of complications

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[11]Cf. Appendix (C), pp. C-6-7. In this opinion there are numerous implicit assumptions about the community, and "young people", that might or might not be valid. The opinion, however, is thought to be both honest and informed.

because it involved two or more separate banks, each responsible for maintaining and managing its own personnel. Consequently, it was thought that a conflict of interest between two corporate entities and two boards of directors might result. For this reason, an officer of First and Merchants expressed the opinion that movement of personnel was easier in the merged system, and that the holding company, as the prime organization, could not possibly achieve this flexibility.

<u>The Position of Bankshares</u>

<u>Increased Organization Size Benefits both the Holding Company and Merged System.</u>[12] Bankshares' management saw both forms gaining relative to an individual bank in Virginia when competing for and holding management talent, as the result of increased size. Larger organizations have the staff and organization to undertake training programs to help speed the development of personnel entering the banking industry for the first time, and they have employee benefits that are superior to those provided by small banks. However, in the competition for young executive talent Bankshares argued that the holding company offered more top executive positions than a comparable sized branch organization, i.e., each affiliate has a president.

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[12] Cf. Appendix (A), pp. A-15-16.

Affiliation is a Solution to Management Succession in the Holding Company.[13] Bankshares cited as an advantage of both forms--as contrasted to an individual bank in Virginia--the fact that they both provide a solution to the problem of management succession. In fact, three of the banks which joined Bankshares had a management succession problem, as was said of most of the other banks that approached Bankshares on an unsolicited basis. Each of the three banks was supplied a new president from within the system.

Discussion

The only point made in the literature is that larger banks typically are superior to smaller banks in attracting and keeping management talent: "As is true of any of the larger enterprises, there are more and varied opportunities for able individuals interested in banking as a career with a group of banks, than within a single unit."[14] Larger institutions have higher salaries, more extensive employee benefits, training and educational programs, as added incentives for employment. Thus, the literature supports the position that these benefits are attributed to increased size rather than to the type of organization.

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[13] Ibid., p. A-16.

[14] Hogenson, op.cit., p. 143.

Employee Benefits. In Virginia where holding companies and merged systems are actively competing in major markets throughout the state, neither appears to have an advantage in this area. Table VII-I shows that employee programs are generally shared by holding companies and merged systems alike.

TABLE VII-I

EMPLOYEE BENEFITS AND PROGRAMS COMMON TO ONE OR MORE OF THE MERGED SYSTEMS AND HOLDING COMPANIES OPERATING IN VIRGINIA

-- Retirement Plan
-- Group Life Insurance Plan
-- Hospitalization and Major Medical Plan
-- Profit Sharing Plan (officers and staff)
-- Employee Training Programs
-- Personnel Department
-- Centralized Recruitment
-- Employee Education Programs

NOTE: Data from 1962-1966 Annual Reports of: (1) First Virginia Corporation, (2) First and Merchants National Bank, (3) Virginia Commonwealth Bankshares, (4) Virginia National Bank, and (5) United Virginia Bankshares.

There is one aspect of employee benefits, however, where it is clear that there may be a difference between the two forms. After a merger, the corporate benefit plan automatically extends to the new employees. But after a holding company acquisition it is not required that the benefit plan for the

group cover the new affiliate. Consequently, it may be that as more and more banks are added by direct merger, there are increasing and sometimes very difficult problems in merging existing benefit plans. It appears, therefore, that the holding company does not face comparable difficulties. This conclusion is supported by the results of one study that found uniform plans and fringe benefits in only one-half of the holding companies surveyed.[15]

Comments on First and Merchants' Flexibility in Movement of Personnel Argument. First and Merchants' argument that greater flexibility in movement of personnel is a benefit of the merged form is probably valid. First, it is clear that the question of moving management personnel is internal to the merged organization. By the way of contrast, changes in holding company management involve different corporate organizations. On this point, the chief officer of the lead bank of a Virginia holding company, which also has some branches, suggested that it makes a great deal of difference if he is dealing with one of his branch managers or the president of an affiliate. The latter situation, he said, involves a greater risk of administrative conflict since a matter such

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[15]Fischer, Bank Holding Companies, op.cit., pp. 87 ff.

as movement of a key manager in an affiliate required "selling", whereas in a branch the change could be "directed".

Organizations of both forms which have centralized recruiting and which have training and benefit plans achieve flexibility in movement of personnel, particularly where such activities are specifically aimed at solving the problem of management succession. For instance, Bankshares quickly and without difficulty provided top management from within its organization for three of the banks that joined.[16] Additionally, movement of management in a holding company has the same benefit First and Merchants alleged for a merged system. It is not necessarily a "lifetime job". It may be the stepping-stone to jobs of greater responsibility. However, the implication of "local autonomy" in the holding company form seemingly gives greater supposition to remaining in one location because it appears to contain hypotheses regarding motivation, the importance of the community, and the interests a bank officer has in being part of a community.

On balance, it is difficult to generalize on the issue of flexibility in movement of personnel. However, control of personnel seemingly is easier in the merged form because it is more difficult to "direct" changes in the holding company.

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[16] Cf. Appendix (A), p. A-16.

First and Merchant's Fewer Personnel Argument. First and Merchants' position that the merged form requires fewer personnel at the policy development and operating level is probably valid for several reasons. First, in those areas where a merged system can integrate operations and a holding company cannot, there may be savings of both management and staff through the consolidation of these functions. Second, a merged system clearly requires fewer directors since holding company affiliates continue to require legal boards in each of their separate banks. And third, lesser management skills may be needed to fill the top position in a branch when contrasted to a comparably sized and functioning holding company affiliate.

The first two reasons why a merged system requires fewer personnel need no amplification, as the potential savings are clear in each case. The third reason, however, requires brief comment. Here, the past chief officer of both a holding company and a large bank in Virginia argued that the abilities required of an affiliate president are more extensive than for a branch manager. The affiliate president has to deal with his board of directors as well as the community; and the reputation of the bank depends, to a great extent, on his performance. By the way of contrast, it was this officer's experience that a branch manager benefits from the "marketing image and reputation" of the home office. Therefore, the

branch manager does not have the same complexity of administrative and marketing problems as the affiliate president. And if this argument is valid, then a merged system can operate comparable sized offices with a lower order of managerial skills. Consequently, it may be easier to fill the management needs of a merged system than a holding company.

On the other hand, both forms--when compared to a unit bank--can save on officers and employees where they can staff for limited banking services in branches throughout their systems. Only deposit facilities may be needed in locations which would otherwise not generate enough business to support even the smallest unit bank.

> "Advocates of branch banking maintain that because of the ability to centralize some functions, and because it is unnecessary to erect expensive buildings for each office, a branch system can provide full banking services in areas which could not support even a small unit bank offering limited services."[17]

Additionally, several other forces come into play in the efficient use of personnel by both types of systems when compared to a unit bank. First, the experiences of the organizations studied suggest that there may be a tendency for expanding systems to upgrade and broaden the scope of services

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[17] Federal Reserve Bank of Richmond, loc.cit., Monthly Review, July 1963.

in a new marketing area.[18] Thus, expansion of services may more than offset any savings in numbers of personnel which may otherwise benefit the organization in aggregate. Also, this study has shown that acquisition does not necessarily result in a reduction of personnel, i. e., corporate policy may dictate that any excess personnel be retained, and that attrition reduce the staff over the long run.[19]

III. OPERATING ECONOMIES

As suggested by the literature, large banks--whether merged or holding company--clearly ought to be able to achieve operating economies over smaller unit banks.[20] The critical question, however, is: "Which of the two forms--a holding company or a merged system--can achieve greater operating economies?" On this issue, both First and Merchants and Bankshares cited operating economies as an advantage of their respective form of organization.

The Position of First and Merchants[21]

First and Merchants preferred the merged form since it led to operating economies in areas such as (1) purchasing,

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[18] Cf. Appendix (A), Table A-II; Appendix (C), Table C-II.

[19] Cf. Appendix (C), p. C-13.

[20] Cf. Chapter V, pp. V-6-10.

[21] Cf. Appendix (C), pp. C-12-13.

(2) insurance, (3) data processing, and (4) personnel administration. On the other hand, it was the position of First and Merchants that economies in these areas can be offset by the cost of new services, improved quality of existing services and other factors. For example, smaller banks usually can be integrated into the system with greater ease. Merger with a larger bank tends to involve problems involving functions and personnel in the merged bank normally centralized in the home office. On this subject a First and Merchants officer said:

> "Let me say that the hoped for economies have not been as realistic as we had thought they would be, and we have not experienced them yet. We hope to in the future, but I think we would make a very serious mistake if we tried to achieve economies through a negative approach. I consider reducing the merged staff by arbitrary laying-off or just saying you do not have a job because we eliminated your position to be a terrible mistake to make at the local scene.
>
> In no case have we dispensed with personnel services as a result of merger. Normal attrition has taken care of this problem. That has been a policy long before the passage of the merger law."[22]

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[22] *Ibid*, p. C-13.

The Position of Bankshares[23]

Bankshares' position was that both forms share many of the advantages attributed to larger banking units: (1) centralization of support functions, i.e., to purchase supplies and system advertising, and (2) use of specialists for trust, legal, tax, accounting, data processing, and other services. The relative economic merits of one form as compared to the other were described by an officer of Bankshares in these terms:

> "My feeling is that selection of an organizational form will in time (perhaps not initially) be primarily a matter of economics. That is to say initially the selection of an organization form may be based on evaluation of factors (i.e., legislative) then existing, but in the final analysis the choice will be proven out by economics. For example, if a holding company cannot operate just as effectively and efficiently as a branch system, then there is no reason not to make the holding company one merged institution (assuming this is feasible as it is in Virginia)."[24]

Bankshares thought that its experiences and the growth of holding companies in Virginia and elsewhere suggest that the holding company form is generally competitive with merged systems; or if not, there are other factors which tend to offset any

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[23]Cf. Appendix (A), pp. A-6-7.

[24]*Ibid.*, p. A-7.

operational inefficiencies--the <u>de novo</u> branching advantage in Virginia.

<u>Discussion</u>

Clearly, big banks of both forms ought to benefit from economies of scale over smaller unit banks:[25]

> "Empirical studies of this issue (52) are subject to both conceptual and methodological difficulties, (53) but they suggest that (a) there are significant economies of scale in banking (i.e., costs per unit of output decline as size increases) as bank size increases up to $10,000,000 in deposits and there may be some less significant economies beyond that size; (54) (b) branch banks tend to have higher total costs than unit banks of equal deposit size (55) but differences in costs between branch and unit operations decrease rapidly, as size increases; (56) and (c) it is doubtful that a holding company can achieve the same economies of operation as a branch system (57)."

However, the answer to the question whether a holding company or a merged system can achieve greater economies of operations is not clear from either the literature or the experiences of the organizations studied.

The merged form has one advantage over the holding company, but the extent of this advantage largely depends on the objectives and policies of a particular management group, not

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[25]Haynes and Phillips, Jr., <u>op.cit.</u>, p. 30.

on universally valid standards. Greater operating economies are theoretically possible in a merged system because some operating functions cannot be combined in a holding company--the corporate entity of each affiliate requires that trust accounts, and bond and loan portfolios be separately maintained. Consequently it appears that a merged system has the potential for a somewhat greater degree of economy than a holding company, assuming all things are equal:

> "Most commentators on banking concentration agree that the close integration typical of branch systems makes greater economies possible than those achieved in holding company banking. It should be pointed out, however, that many of the large group systems make extensive use of branch offices in those locations where they are permitted by law."[26]

However, within the constraints of the assumption that if the organizations studied are comparable in all other areas affecting profitability, then the data in Table VII-II suggest that the question of "efficiency--type of corporate organization" is a matter of "six of one and a half dozen of the other" in Virginia, when measured by two broad indicators of operating efficiency: (1) earnings on deposits, and (2) earnings on capital.[27]

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[26] Lamb, op.cit. pp. 236-37.

[27] A statistical test comparing: (1) the average of the five year earnings to deposits ratios shows a t value of .10,

TABLE VII-II

RATIOS: NET OPERATING EARNINGS TO TOTAL DEPOSITS AND NET OPERATING EARNINGS TO CAPITAL FOR FIRST AND MERCHANTS AND BANKSHARES, 1962-1966

Year	Bankshares Earnings/ Deposits	Bankshares Earnings/ Capital	First and Merchants Earnings/ Deposits	First and Merchants Earnings/ Capital
1962	.89	9.3	.97	10.2
1963	.88	9.9	.91	9.4
1964	.98	12.6	.99	10.4
1965	.97	12.2	.99	11.2
1966	1.03	13.1	1.10	12.6
5 year avg.	.950	11.42	.992	10.76

NOTE: Data from Appendix (A), Table A-III, Appendix (C), Table C-III.

The resolution of the "efficiency--type of corporate organization" question boils down to a choice between a position that: (1) the merged form is more efficient because of closer integration in areas such as trust, loan and investment portfolios, or (2) there is no significant difference between

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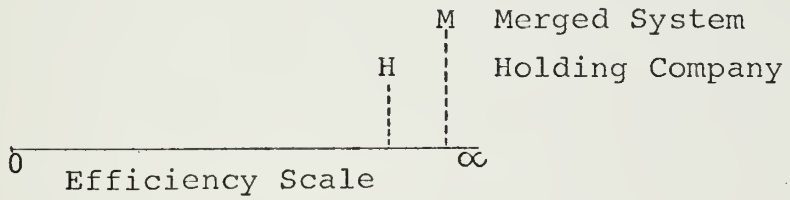
and (2) the average of the five year earnings to capital ratios shows a t value of .68. With 8 degrees of freedom, a t value as large as 2.306 would occur by chance alone with a probability of .95 when the samples are from the same distribution. These data, therefore, do not support an hypothesis that the samples are from different populations.

the forms as suggested by the profitability experiences of the organizations studied. The better choice is the first conclusion because the validity of the quantitative comparison is severely limited by its constraining assumptions, small sample size and the short period of measurement.[28]

The relative efficiency of the two forms, however, also depends on the objectives and policies of the individual management group. Clearly, decisions made by management on the extent of centralization or decentralization will affect integration at all levels of the organization. This suggested relationship can be visualized as follows:

A. Assuming the merged system as a form of organization is more efficient than a holding company--because of closer integration of operations--it will be to the right of a holding company as measured by points M and H on an efficiency scale.



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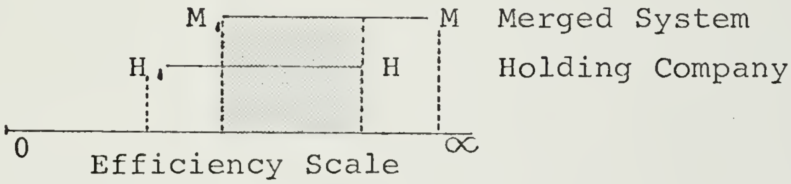
[28] In measuring differences in operating economies between the two forms there would be problems similar to those encountered in measuring economies of scale between large and small organizations. Many factors apart from the type of organization could contribute to differences in profitability. Consequently, valid research results require answers to questions

B. But, assuming there is a range of efficiencies--depending on the objectives and policies of a particular management--then integration of operations are likely to vary from bank to bank and there could be any number of points on the efficiency scale where both forms are the same, as represented by the shaded area.



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such as: (1) "What is efficiency in commercial banking?", (2) "How is efficiency measured?", (3) "How can the holding company and merged system be reliably compared considering basic differences in: (a) size, (b) location, (c) business mix, (d) organizational form, (e) legal factors, (f) management, (g) markets, and (h) other factors?" This study was not intended to and cannot resolve these questions.

CHAPTER VIII

THE EXPANSION DECISION: FINANCIAL CONSIDERATIONS

This chapter deals with four financial considerations commonly thought to be significant by bank managements in their selection of a form for expansion. These include: (1) credit and funds mobility, (2) acquisition and control of capital, (3) economic benefits to the acquired bank's shareholders, and (4) diversification of risk. These considerations cover a variety of unrelated financial subjects. The order of discussion first treats two issues considered by both First and Merchants and Bankshares; and second, two issues considered by one of the managements and not by the other.

I. CREDIT AND FUNDS MOBILITY

Mobility of funds was a point cited by both Bankshares and First and Merchants. Bankshares position was that this is an advantage not peculiar to the holding company vis-a-vis a merged system, but rather as contrasted to an individual bank in Virginia. On the other hand, First and Merchants suggested that a merged system may have greater potential than a holding company in this area.

The Position of First and Merchants

Mobility of Funds is Greater in the Merged Form.[1] First and Merchants' management thought the merged form had greater potential for credit mobility because a branch in a high loan area could have 100 percent or even more of its deposits invested in loans; this was possible since a branch was constrained only by the limits placed on the system as a whole. By the way of contrast, a holding company competitor in the area, in theory, could place the same amount of loans with the participation of other affiliated banks. However, an officer of First and Merchants argued that participation among several banks did not work too well in practice.

> "... Participation must go through the separate boards of directors of a holding company, and each may not react the same way. The extension of credit is personal judgment--it is not an exact science by any manner of means. While the holding company could say what will be done in a certain situation, the board of directors of an affiliate is still required by law to exercise independent judgment, or be subject to legal action."[2]

The Position of Bankshares

Credit and Funds Mobility are Comparable in Both Forms.[3] Bankshares' position was that holding companies, like merged

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[1] Cf. Appendix (C), p. C-8.

[2] Ibid.

[3] Cf. Appendix (A), pp. A-18-19.

systems, have the capability of pooling lending resources among affiliates to serve the growing credit requirements of industry. For example, to facilitate the flow of funds throughout its system, Bankshares developed a loan participation procedure and encouraged its banks to pre-clear large loans that needed to be shared throughout the system. It was an opinion of an officer of Bankshares that the use of: (1) rapid communication devices, (2) central credit files, (3) charge cards, plus (4) the efficient use of data processing equipment, will ultimately remove any advantages branch systems now enjoy in the area of credit mobility.

Discussion

"Outset loan" participation arrangements were a limiting factor on holding company credit mobility until eliminated by an amendment to the Bank Holding Company Act in 1966.[4] Now the literature suggests that there are no significant restrictions on the purchase of loan paper or on loan participation between subsidiaries of holding companies.[5] Consequently, differences in funds mobility between the holding company and merged form have narrowed, but not disappeared.

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[4] An "outset loan" involves participation agreement among the affiliates prior to the placement of the loan.

[5] Lawrence, op.cit., p. 10.

<u>The Role of Directors Influences Funds Mobility</u>. As a practical matter the question of mobility of funds is directly related to the role of the directors in an organization. Because of this it is argued--in this study--that the holding company typically does not enjoy the same funds mobility as the merged form.

In a merged system there is only one board of directors, but in a holding company there may be many boards. In moving funds within a holding company the individual affiliate directors have legal responsibilities and liabilities not mitigated in any sense by a standard participation agreement, or the lending policy of the holding company. These responsibilities and liabilities particularly apply where the affiliates are less than 100 percent owned, for here the directors are required to protect the rights of the minority in the same way that they protect the rights of the holding company stockholder. Because of this, affiliate directors may have conflicting interests on matters relating to funds mobility which could, from a practical standpoint, constrain funds movement throughout a holding company system. For instance, under conditions of credit rationing, affiliate directors might face the problem of satisfying the loan demand in their local service area as opposed to participating in loans of other prime customers in the eyes of the holding company. But, this question of separate directors is "theoretical" in the sense that it would

not be likely to generate a problem in, say, nine out of ten working days. However, it would not be "theoretical" when and if it came up on the tenth day, because that is when it would be least welcome by management.

Through 1966, however, there appears to be no significant difference in funds mobility for the systems studied. The data in Figure VIII-1 suggest that the expansion of loans, measured as a percentage of deposits, between Bankshares and First and Merchants was comparable, assuming, of course, equally able loan officers in each organization, and equally good lending opportunities in each banking community.

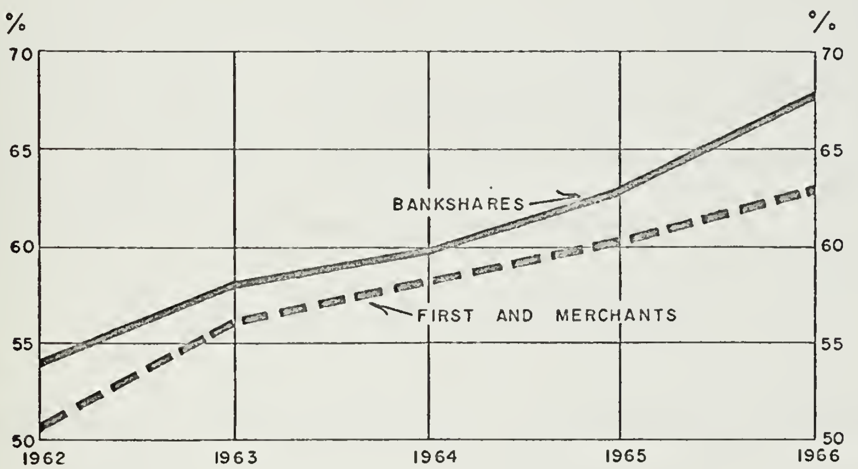

FIGURE VIII-1

COMPARISON OF FIRST AND MERCHANTS AND BANKSHARES LOAN TO DEPOSIT RATIO: 1962-1966 (FROM APPENDIX A, TABLE A-III; AND APPENDIX C, TABLE C-III)

Branch Structure and Location Influence Funds Mobility. Mobility of funds within a branch structure will depend on the types of location branches serve; there are some locations where deposits will clearly exceed loan demand, a wealthy urban community; there are are some locations where loan demand will exceed deposits, a business community; and there are some locations where loans and deposits about balance. Consequently, it is difficult to generalize on the subject of comparative funds mobility between not only holding companies and merged systems, but also among individual holding companies and individual merged systems. Therefore, a relevant question for bank management appears to be: "Which type of organization uses the different types of banking location to best advantage?" For instance, does one form of expansion do better in high loan locations, where the customers are firms with multi-plant or office locations elsewhere in the state?

II. RAISING AND USING CAPITAL

Both First and Merchants and Bankshares cited "financial flexibility" as an advantage of their respective forms. However, Bankshares use of the term was different from First and Merchants in that: (1) it was broader in scope because it concerned both raising and allocating capital, and (2) it was more nearly consistent with the concept of "financial flexibility" in the literature. The following discussion explores

the possibility that both Bankshares' and First and Merchants' managements have equally valid points-of-view, depending on the respective definition of the term.

The Position of First and Merchants

To First and Merchants Financial Flexibility Meant Easier Control over the Capital Account.[6] First and Merchants' management preferred the merged form because it resulted in greater financial flexibility in the sense that one capital account was easier to control in a merged system: "It's much more easily controlled and manipulated than if it were in many independent units." Also, it was the position of First and Merchants that a local bank name was an advantage when selling equity or debt in the market area of the bank. This advantage was explained by a First and Merchants officer as follows:

> "To buy First and Merchants National Bank stock there is acceptability of the equity and debt instruments at the local community and this would be much greater than it would be for a holding company that does not identify to any bank. Today there is a problem, so the bankers say, in the identification of a holding company with a bank in the community, i.e., people in the community tend to get mixed

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[6] Cf. Appendix (C), pp. C-9-11.

> up. However, this does not apply to a sophisticated investor, but to the man on the street, it does."[7]

The Position of Bankshares

To Bankshares Financial Flexibility Meant More Ways to Raise Capital.[8] Bankshares' management preferred the holding company form because it had more flexibility in raising capital. Two reasons were cited for this: (1) financing could be done either at the level of the affiliated banks or at the holding company level, and (2) financing could be done in more ways and with more ease than in a merged system. Also, use of leverage and raising capital at lower cost and with greater ease were said to be important benefits resulting from financing at the holding company level:

> "The potential of the holding company is to maximize leverage, using debt financing to a greater extent than through a bank. After all the examiners who examine banks are going to be more restrictive on how much debt they are going to allow a bank to issue. They would not have the same concern about a holding company since we do not have any depositors. It is a different thing if we go under. If we fail it has nothing to do with the banks. We are just the stockholder. The stockholder can go broke, but the bank is still in operation...

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[7] Ibid., p. C-10.

[8] Cf. Appendix (A), pp. A-7-9.

> We could issue short-term debt at a rate we wanted and that the market would permit. If a bank tried to do the same thing there would probably be a limitation on the rate. If the debt instrument was construed as a deposit by the Federal Reserve Board then it would be subject to reserve requirements and to the rate limitations of Regulation Q. I don't think any holding company yet has maximized the possibilities. But every now and then you see where somebody has used one."[9]

A recent example of the greater "financial flexibility" of the holding company involved State-Planters. In this case the bank could not obtain property needed for a new building and still provide the property owner with a tax-free transaction because the bank could not issue stock, except under stock options, in a cash sale or in a merger. However, the holding company could obtain the property on a tax-free basis by exchanging its stock for the land.

Discussion

First and Merchants' Control of the Capital Account Argument. There appear to be some essential differences between the forms in control of the capital account that may be important to management. Seemingly these differences are complicating circumstances in the case of the holding company.

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[9] Ibid.

For instance, in a merged system the transfer of capital funds is internal to one corporation, while in a holding company more than one corporation is involved. In the latter case, problems may arise involving minority interest and the responsibilities of directors on such issues as: (1) dividend policy, (2) rates on up and down stream loans,[10] or (3) allocation of costs to affiliates for holding company services. Furthermore, in the merged system there is one accounting system and one set of financial statements, while in the holding company each affiliate has its own statements and each affiliate may have its own accounting system. Consequently, the operating results of individual holding company affiliates are a matter of public record for shareholders and investors, while in the merged system branch profitability is an internal matter. Put together, these differences suggest that management in the merged system probably does have more direct control over the use of capital. It is a matter internal to one corporation, a single group of management, and one body of stockholders.

<u>First and Merchants' Greater Acceptance of the Merged System's Financial Instruments at the Local Level Argument.</u>

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[10] Section 23A of the amended Federal Reserve Act permits loans between affiliates--both bank affiliates and holding company subsidiaries--with restrictions that the total amount to one affiliate shall not exceed 10 percent of the lending affiliate's capital and surplus, or that the total amount to all affiliates shall not exceed 20 percent of the lending affiliate's capital and surplus.

Presumably the question of "bank name" re selling a bank's stock contains assumptions about the motivations of buyers of stock and suppliers of capital. Clearly, there are different kinds of buyers with different motivations and objectives in the capital markets. Consequently, most arguments as to whether unit banks, holding companies or merged systems can raise capital most easily are meaningless in the sense that they omit considerations of the basic fact: "Who, what, and where is the market for different kinds of securities?" Each situation--in essence--"turns" on these considerations.

<u>Bankshares' Flexibility in Raising Capital Argument</u>. If flexibility in raising capital is a significant advantage for the holding company, then it should result in some definitive economic benefit. This might be a lower cost of capital or improved access to the capital markets, since these considerations influence profitability and growth. Consequently, the critical question is: "Are the benefits to one form significantly greater than to the other?"

While both forms can use equity and debt financing, there are fewer constraints in the use of debt financing in the holding company. Therefore, the holding company appears to have greater potential in the area of financial leverage. First, as suggested by Bankshares, the holding company may be able to use more debt than a bank because the regulatory agencies are not concerned by depositor protection at the

holding company level. For instance, use of the short-term promissory notes by banks--authorized by the Comptroller of the Currency (Saxon) in 1963--was virtually terminated by the fact that the Board of Governors of the Federal Reserve System classified them as deposits. This made short-term notes subject to the reserve and interest ceiling rate requirements of the Fed.[11] On the other hand, holding companies have no such constraint.

Second, there are limitations on the use of capital debentures or notes specified for national banks by the Comptroller which do not apply to holding companies.

> "... the principal amount of capital debentures outstanding at any time, when added to all other outstanding indebtness of the bank, except those forms of indebtness exempt from the provisions of 12 U.S.C. 82, shall not exceed an amount equal to 100 percent of the bank's unimpaired paid-in capital stock plus 50 percent of the amount of its unimpaired surplus fund."[12]

Moreover, the non-banking nature of a holding company may result in a more liberal attitude on the part of its management toward the use of debt. This possibility is suggested by the

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[11] George W. McKinney, Jr., op.cit., p. 98.

[12] Ibid., p. 90.

comment of a Bankshares officer that the holding company could "go under" and the individual banks would not be affected, at least directly. These differences suggest that holding company management could justify the use of more extensive debt in order to maximize leverage. And, under such conditions the holding company form might experience a lower long run cost of capital.[13]

However, from the point-of-view of the merged form it is argued--in this study--that a lower cost of capital may be more a function of the size of an organization than the type of an organization. In support of this position one study found that large holding companies were able to sell their stock at rates often competitive with the largest independent banks in an area.[14] This finding implies comparable capital costs for large organizations of both forms, rather than an advantage to either. Furthermore, assuming all other factors affecting the cost of capital are comparable, the data in Table X-I suggest there is no significant difference in Virginia

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[13]This assumption is based on the "traditional" viewpoint in finance that a firm's cost of capital can be lowered by the use of a judicious amount of debt.

[14]Fischer, Bank Holding Companies, op.cit., pp. 124-25. The study also found that: (1) small holding companies apparently had little advantage in lowering capital costs since affiliates usually raise their own capital, but (2) a small bank in a large system could get additional capital at considerable savings.

between three holding companies using debt and two merged systems not using debt, during the years 1965-1966.[15] The holding companies, as of December 31, 1966, had debt to equity ratios ranging from a low of 24.9 to a high of 43.0 percent; debt was financed at rates ranging from 4 3/4 to 4 7/8 percent.

TABLE VIII-I

COST OF CAPITAL COMPARISON OF THREE HOLDING COMPANIES AND TWO MERGED SYSTEMS IN VIRGINIA FOR THE YEARS 1965-1966

Year	Three Holding Companies Weighted Cost of Equity and Debt	Two Merged Systems Cost of Equity
1965	6.2%	6.3%
1966	7.4%	8.1%
2 year average	6.8%	7.2%

NOTE: The cost of equity capital is approximated by the earnings price ratio; the cost of long term debt is approximated by the rate on outstanding debt.

Data from J. C. Wheat and Company, Richmond, Virginia, Virginia Bank Stock Annual Review, 1965-1966; and 1965-1966 Annual Reports for First and Merchants National Bank, First Virginia Corporation, Virginia Commonwealth Corporation, Virginia National Bank and United Virginia Bankshares.

But, to the extent the three holding companies have been able to use 4 3/4 to 4 7/8 percent debt financing in the

[15]Comparison of the average cost of capital indicates a t value of .37. With 2 degrees of freedom, a t value as

place of higher cost equity, and recognizing that interest on debt is a deductable expense, then they may have gained some economic benefit which is not reflected in the admittedly rough approximation of cost of capital shown in Table VIII-I.

The cost of capital issue narrows down to a choice between a conclusion that: (1) the holding company benefits more than the merged system because of its greater potential for leverage, which may result in a lower long run cost of capital, or (2) there is no significant difference as suggested by the experiences of holding companies and merged systems in Virginia. The first of these conclusions is thought to be the better choice because the validity of the quantitative data supporting the "no difference" hypothesis is severely limited by the small sample size, the short time span measured and the limiting assumption in this admittedly rough approximation of cost of capital. Consequently, a clear resolution of the "economic" consequences of this issue can come only from future empirical research, and only after the banking industry, as a whole, has adopted practices which make more effective use of debt financing.

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large as 6.965 would occur by chance along with a probability of .95 when the samples are from the same distribution. These data, therefore, do not support an hypothesis that the samples are from different distributions.

IV. ECONOMIC BENEFITS TO THE SHAREHOLDERS OF THE ACQUIRED BANK

Only Bankshares cited economic benefits for the shareholders of the acquired bank as a significant consideration in selecting a form of expansion; it was identified as an advantage applicable to both forms.

The Position of Bankshares

There are Economic Benefits to the Acquired Bank's Shareholders.[16] Bankshares' management thought that the financial terms of an acquisition were important and, in some cases, a decisive influence in a bank joining their holding company. Policy was to acquire banks on a book value basis, adjusted to reflect current value of assets. The economic benefit to the stockholders of the bank being acquired resulted from the fact that their stock, like the stock of many small banks in Virginia, generally sold at or below book. On the other hand, Bankshares stock generally sold above book and, at times, had been as high as 200 percent of book. An officer of Bankshares illustrated this point as follows:

> "Assume you are a large holding company or a large bank and your stock is selling at a substantial price above book. You can afford to offer

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[16] Cf. Appendix (A), pp. A-17-18.

> somebody book for book and at the same time give him, say, 100 percent appreciation on what he can get for his stock on the market. One day he has stock certificates worth $100 and just by joining you in a merger or holding company his stock is immediately worth $200. It is hard to gauge the influence that this has, but it is important. It may be the real clincher. We also talk to management about local autonomy, tell them how we operate, etc. We tell them the two or three requirements that you have to hammer on: (1) that their board is responsible for running the show, (2) that Bankshares as a stockholder is basically a service organization, (3) that we are interested in doing bigger and grander things and most importantly to earn some money for our stockholders. But, who knows really how much impact philosophy has versus the dollar?"[17]

Premiums for banks in Virginia interested in joining a system were thought to be less likely in the future because the speculative interest in merger candidates has bid up the stock of banks with acquisition potential.

Discussion

The literature clearly supports the position that affiliation with a holding company can result in economic benefit to the acquired bank's shareholders. "Opportunity to gain a

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[17] _Ibid._, p. A-17-18.

profitable premium through exchange of stock with a group" is among the three most frequently cited reasons for joining a holding company.[18] However, as pointed out by Bankshares, this benefit is not limited exclusively to holding company affiliation. Direct merger also provides a premium to the shareholders of the acquired bank when the acquisition is made on a book to book basis and when the acquired bank's stock is selling at or below book. Seemingly, the greater liquidity of the shares of big banking organizations--of both forms--is an important attraction in merger or affiliation. Premiums received commonly are attributed to the better marketability of shares of big organizations, as compared to small banks, than to almost any other factor.

Table VIII-II illustrates Bankshares' point that premiums over book were common to both forms of expansion during the years 1962-1966:

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[18] Fischer, American Banking Structure, loc.cit. The most frequently cited reason for affiliation is "desire of major stockholders for more liquid holdings."

TABLE VIII-II

COMPARISON: BANKSHARES AND FIRST AND MERCHANTS STOCK PRICE AS A PERCENT OF BOOK VALUE FOR THE YEARS 1962-1966

Year	Bankshares	First & Merchants
1962	——	167
1963	190	180
1964	200	210
1965	202	183
1966	183	163

NOTE: Data from J. C. Wheat and Company, Richmond, Virginia, Virginia Bank Stocks Annual Review, 1962-1966.

V. DIVERSIFICATION OF RISK

Only First and Merchants cited diversification of risk as a significant consideration in the selection of a form of expansion.

The Position of First and Merchants

Diversification of Risk is an Advantage of the Merged System.[19] First and Merchants preferred the merged form because it provided for greater diversification of risk in the loan portfolio and investment account.

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[19] Cf. Appendix (C), p. C-9.

Discussion

The literature generally holds that larger banking organizations of all types--unit banks, holding companies, and merged systems--are better able than small banks to diversify risk in their loan and investment portfolios. These larger organizations typically serve markets of greater size, and when these areas have different economic characteristics, this diversification can work to reduce the risk in the loan portfolio. Similarly, larger banking organizations have more funds and can gain greater diversity in their investment portfolios, this--theoretically at least--minimizes the impact of any one loss.

CHAPTER IX

THE EXPANSION DECISION: MARKETING CONSIDERATIONS

This chapter addresses itself to three marketing considerations, thought to be significant by the managements in their selection of a form of expansion. These include: (1) larger lines of credit, (2) marketing identity, and (3) new and expanded services. Also, this chapter examines some marketing related elements of First and Merchants' and Bankshares' expansion strategy.

I. LARGER LINES OF CREDIT

First and Merchants argued that expansion by direct merger results in an increased line of credit for any one customer, as the result of increased capital. Bankshares did not comment on this point.

The Position of First and Merchants

Larger Lines of Credit.[1] First and Merchants, in 1962, could lend one customer approximately $1.5 million; nine Virginia banks were required to participate to lend $5.0 million. However, after expansion of its capital as the result of mergers, First and Merchants could lend approximately $3.5

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[1] Cf. Appendix (C), p. C-9.

million in 1966; just a few large Virginia banks were needed to lend $5.0 million.

In the absence of the merger law the only way the bank's capital structure could have been increased would have been through retained earnings or the sale of additional stock. An officer of First and Merchants expressed the opinion that capital funds definitely would have been much less had not mergers taken place. Also, he said First and Merchants was still not the size desired when measured by either capital or deposits.

Discussion

The following paragraphs focus on two points. First, larger lines of credit are important in other ways not discussed by First and Merchants. Second, larger lines of credit are common to both forms as a function of increased organization size, independent of the form of corporate organization.

The larger lines of credit argument is applicable to only a small percentage of a bank's business, say 1-5 percent of the number of borrowers in any given market area. But, these few borrowers are of much greater importance with regard to the total volume of loans. Furthermore the size of the credit line is an important defensive shield in keeping other large banks from acquiring business in the "home area" banking community. And, at the same time it provides a bank

with an opportunity to operate in a larger market. These considerations were clearly recognized by bankers in Virginia as a justification and need for larger banking units in 1961, and were important in bringing about liberalized branching legislation in 1962.

> "Virginia is surrounded by banks in North Carolina, Maryland and the District of Columbia with greater lending ability than any of the Virginia banks.
>
> Consequently, the financing for big commercial and industrial projects in Virginia is being supplied by out-of-state banks with increasing frequency. These big loans are profitable business for the banks and they create deposits...
>
> Beyond doubt, Virginia bankers say, this state is losing banking business to North Carolina. A recent example was the H. K. Porter Co., whose $2,650,000 electrical transformer plant at Lynchburg was financed by a North Carolina bank and whose Disston Saw Division in Danville, which cost $1,500,000 to $2,000,000, was also financed in North Carolina.
>
> No single Virginia bank could have made those loans, but either of two banks in North Carolina could.
>
> The implications found in North Carolina financing of Virginia commerce and industry are important. If the borrower establishes banking connections in North Carolina, it perhaps becomes plausible for him to build his next plant or expansion in North Carolina instead of Virginia."[2]

A larger line of credit is common to both forms of expansion; it is primarily a function of increased organization

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[2] _Richmond Times Dispatch_, July 2, 1961.

size, regardless of the corporate form. This position is consistent with the literature and the experiences of the organizations studied. For instance, Figure IX-1 compares the capital of First and Merchants with Bankshares for the years 1962-1966; at the same time it compares First and Merchants to State-Planters, the single largest bank in Bankshares.

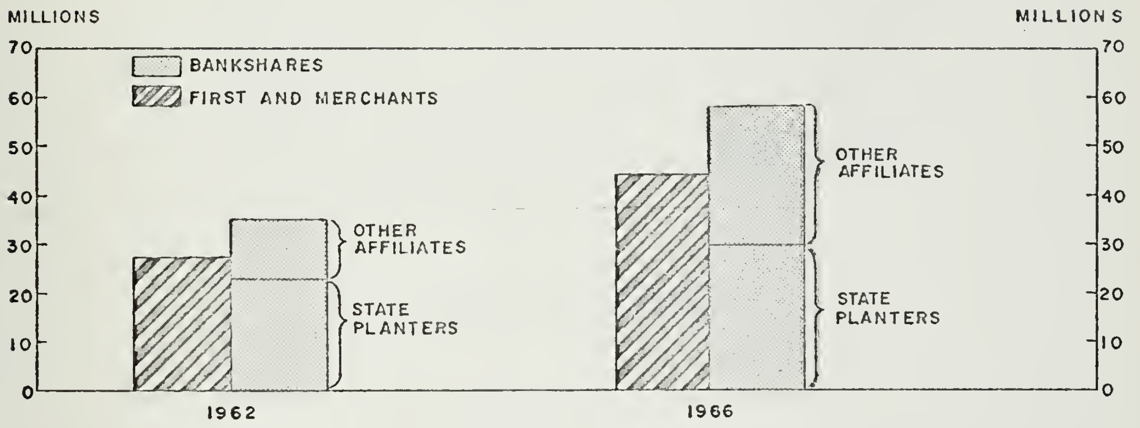

FIGURE IX-1

COMPARISON OF CAPITAL FOR FIRST AND MERCHANTS, BANKSHARES, AND STATE-PLANTERS FOR THE YEARS 1962 AND 1966 (FROM APPENDIX (A), TABLE A-III; AND APPENDIX (C), TABLE C-III)

If the single bank lending limit of State-Planters is used as the measure of Bankshares credit line, then First and Merchants is larger in 1962 and 1966. However, if First and Merchants

is compared to Bankshares on a system basis, then Bankshares has the larger credit line. In this case a "system to system" comparison is the more meaningful representation of the lending power of the two forms:

> "In effect, the combined capital accounts of the banks within a group system permit any local member institution to accommodate the financing requirements of the larger customers. While similar arrangements exist between independent unit banks through correspondents, the closeness of these relationships varies so much as to limit the application of this form of lending. In those group systems whose banking operations are supplemented by branch offices the flow of funds between areas is promoted even further by virtue of the branch form of organization."[3]

II. MARKETING IDENTITY

Both managements considered the question of marketing identity, each alleging certain advantages and disadvantages of a "system image" versus a "local image".

The Position of First and Merchants

<u>A Disadvantage of Expansion by Direct Merger Was the Loss of the Merged Bank's Name.</u>[4] First and Merchants made several points concerning the influence of the merged bank's

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[3]Lamb, <u>op.cit.</u>, p. 239.

[4]Cf. Appendix (C), pp. C-14-15.

name to: (1) management, (2) stockholders, and (3) customers.

In some cases management of the bank to be merged placed a great deal of emphasis on its "local identity". A First and Merchants officer stated:

> "... it is surprising how important an existing bank's name can be to the bank's management. In many instances bank management just does not want the name to disappear, and under the holding company route the name can be continued."[5]

In other cases, First and Merchants' management believed that the surviving bank's name was more important to the acquired bank's stockholders. For instance, if a bank were merged into First and Merchants, the local stockholders would receive First and Merchants stock, i.e., shares in a local bank as opposed to a holding company, which may be located in some other area. Here First and Merchants' management believed the stockholder's tie to a local bank was stronger and provided just as much local identity in a merged system as does the retention of the name for a bank which joins a holding company.

First and Merchants' management believed customers acceptance of its name was excellent in the local community.

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[5] *Ibid.*, p. C-14.

A survey made in the Tidewater area indicated that 80 percent of the old depositors, who had for years been doing business with the acquired bank, associated with the First and Merchants name 24 months after merger.

<u>The Position of Bankshares</u>

<u>The Value of the Marketing Image Varied with the Circumstances.</u>[6] Bankshares' position was that marketing identity works both for and against the holding company. A Bankshares officer said that it was an advantage in local markets where the banking relationship tended to be highly personal and the customer had a banking association of a longstanding nature. On the other hand, the single corporate image of a merged system--or a holding company using a standard affiliate identification, i.e., Marine Midland--tended to be a more important marketing characteristic in areas where the urban customer was attracted to a large branch system for the uniformity of services he received. Here an account was good in any branch in the market area, while in a holding company each affiliate was a separate bank. However, Bankshares management believed that problems stemming from the separate identity of holding company affiliates could to a degree be offset by having wire service verification and a corporate symbol for use by each affiliate. Bankshares took both of these steps.

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[6]Cf. Appendix (A), pp. A-22-23.

Discussion

A strong argument is made in the literature supporting holding companies since this form permits the retention of local identity of an affiliate. However, from a marketing point-of-view it seems impossible to generalize about the value of a bank's name. The value varies with the individual circumstances.

The value of a "local" bank name versus a "system" name depends on considerations such as the areas being served and the types of customers in these areas. For instance, as Bankshares argued, in smaller communities or rural areas where population turnover is low and business and banking associations are of a long standing and personal nature, the name of the "local bank" may be best for customer relations. On the other hand, a "system name" may be a more valuable marketing asset in the larger urban communities or metropolitan centers where population mobility is high and banking services are more likely to be chosen on the basis of convenience and uniformity.[7]

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[7]In the case of Bankshares they started operations without system identification at the local level, but in 1968 announced that affiliates would assume a common identification in early 1969. As quoted from a Bankshares press release, "J. Harvie Wilkinson, Jr., President of United Virginia Bankshares Incorporated, announced today that after lengthy study and consultation with the firm of Lippincott & Margulies in New York City as well as consumer representatives in several of the United Virginia Bankshares cities that all member banks of United Virginia Bankshares will adopt a program of common identification in early 1969. In commenting on this move before

It is also apparent that management can weigh the importance of identity in terms of the customer's banking alternatives. For example, "local identity" is of little consequence if there is no other banking alternative in the community. In such a situation the bank's name could be dropped as the result of a merger with no fear of customer and depositor switching.

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a conference of bank directors from each of the member banks, Mr. Wilkinson referred to the move as a forward step dictated by two geo-economic factors. He referred to the increasing mobility of our population in which 20% of our people change locations each year and in Virginia 90% of those changing locations make their changes to other locations in the state. Wilkinson also called attention to the economic necessity of taking full advantage of overlapping communications and promotional media, a practice which can be substantially augmented by uniform identification.

The first step in this program was naming the corporation's "Edge Act" subsidiary United Virginia Bank International, followed by giving the name United Virginia BankAmericard to the credit card offered by UVB members. Subsequent plans call for a newly designed common logo and for each member bank to be known as "United Virginia Bank" in its respective community and branch trading areas. In order to achieve the continuing local identification presently considered such a valuable part of the holding company concept, an identifying separatism will be achieved by the addition of a localizing suffix. Plans when successfully concluded will result in member banks in United Virginia Bankshares operating under new names as follows: In Richmond - United Virginia Bank/State Planters; In Norfolk - United Virginia Bank/Seaboard National...

Concluding his announcement of the identification program Wilkinson said, 'All of our members eagerly look forward to the execution of this new program. While in many instances our members have achieved success over a period of more than one hundred years with their previous old and respected names, our changing times demand changing images and we believe that nowhere is the demand for change today more noticeable and urgent than in the banking business.' "

Local Identity and the Stockholder. First and Merchants management has a valid argument that merger provides "local identity" for a bank's shareholders. In this case their stock carries the name of their bank, whereas a holding company shareholder does not hold stock in the name of any bank. This argument, however, does not seem as significant as the importance of a bank's name with regard to different markets and customers. Any benefit is limited by the relatively small number of shareholders compared to total customers--in the case of First and Merchants approximately 5,300 shareholders in 1966.

III. SERVICES

New and expanded services was a point cited by both First and Merchants and Bankshares. First and Merchants suggested that a merged system may have greater potential in this area, whereas Bankshares cited expanded services as an advantage not exclusive to either form, but rather as contrasted to the relatively small unit bank in Virginia.

The Position of First and Merchants

Community Service.[8] First and Merchants preferred expansion by direct merger because greater community services

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[8] Cf. Appendix (C), p. C-12.

were thought to be provided through this form of expansion. All of the services and facilities of a merged system were available at the local level, i.e., each branch office could perform any and all services just as if it were the main office.

> "...This is something that definitely can not be done to the same degree in a holding company organization. Direct contact with the specialist in the bank of your choice, as in a merged organization, appears to be a solution which would give the customer more confidence than in the holding company where the specialized services may be performed by a bank of another name, or the holding company."[9]

Expansion By Direct Merger Creates Larger Banking Units.[10] First and Merchants' management believed that expansion by direct merger developed larger individual banking units which were then able to offer larger credit lines and a wider range of services: "Industry is more naturally drawn to the larger financial organizations which can better serve some of their needs."[11]

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[9] Ibid.

[10] Ibid., C-11.

[11] Ibid.

The Position of Bankshares

New Services.[12] Both forms were thought to provide a greater range, depth and quality of banking services to Virginia citizens than a typical unit bank.

> "A direct comparison, however, of holding companies and merged systems is difficult. This would depend on the service objectives of management and the needs of each market area. For example, First Virginia, operating primarily in Northern Virginia, emphasizes consumer business. Therefore, their service structure would be quite different from, say, First and Merchants, operating largely in the Central and Tidewater Virginia areas, which caters, in a fairly balanced manner, to both consumer and industrial accounts."[13]

Bankshares' position was that service benefits stemmed from the ability of the holding company to employ specialists in areas such as trusts, industrial accounts, and data processing. As an example, expanded services of Bankshares in the 1962-1966 period were: (1) Municipal Bond Department, (2) Professional Services Program, (3) College Tuition Loan Program, (4) Computerized Payroll Service Program, (5) One Check Payroll Program, (6) Marketing Department, and (7) Planned operations of credit card program.

Discussion

The literature clearly holds that both forms provide for greater range, depth and quality of banking services as

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[12] Cf. Appendix (A), pp. A-19-20.

[13] *Ibid.*

a benefit of increased size, irrespective of the form of corporate organization. The issue is which form of organization does it more effectively?

Both organizations added new and expanded banking services to the growing number of communities they served.[14] This action suggests that the literature and Bankshares positions draw the more meaningful contrast. That is to say, the more meaningful contrast is between a small unit bank which does not have and cannot afford specialized knowledge and competence in its own personnel and must rely on its correspondent banks for providing these services, and both the large merged system and holding company, which can and do provide more and better services at the local level.

Furthermore, Bankshares certainly has a valid point regarding the difficulty of drawing a direct comparison of the services of these large banking organizations. Clearly, management's marketing objectives and the areas and customers served are factors which influence service at the local level. Consequently, direct comparisons of the two forms are meaningless unless these circumstances are considered on an individual basis.

IV. MARKETING STRATEGY

First and Merchants and Bankshares each planned and implemented an expansion strategy aimed at the growth areas

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[14] Cf. Appendix (A), Table A-II; and Appendix (C), Table C-II for a listing of new services for Bankshares and First & Merchants, respectively.

in Virginia. The following paragraphs examine their respective positions in light of the results of their expansion programs during the years 1962-1966.

The Marketing Strategy of First and Merchants

Expand Into Growth Areas.[15] First and Merchants expansion by direct merger was planned on a statewide basis. It was primarily directed at urban and industrial areas which had above average growth potential. Expansion was based on managements' concept that growth in metropolitan areas was more assured than rural areas. For this reason Northern Virginia, Tidewater urban areas, Roanoke, and Lynchburg were considered for expansion. Also, Winchester, Harrisonburg, Staunton, Waynesboro, Bristol, Martinsville, and Danville were attractive because they had more assured industrial growth potential.

An officer of First and Merchants said that merger partners were looked at from the standpoint of what could be foreseen as the future development in their areas.

> "More opportunities to merge were turned down than have actually merged--about three to one. With some of the people that we have known for many, many years, the hardest decision to make was to say no, if according to our analysis,

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[15]Cf. Appendix (C), pp. C-17-20.

> the areas that they represented did not have the required growth potential. Banks like these generally wanted: (1) to share in the future growth and earnings of the First and Merchants system, (2) to solve a management succession problem, or (3) to obtain more marketability for stockholders shares from the merger."[16]

First and Merchants' expansion strategy was highly selective. Management believed selectivity was sound even though other bankers contend it was foolish to turn down a merger because the State of Virginia was going to grow, and if you could merge, merge.

The Marketing Strategy of Bankshares

Expansion was Directed at Growth Areas.[17] Bankshares' strategy was to expand in growth areas and to become a statewide banking system. Growth areas were defined by above average population and industrial expansion. The urban corridor south from Washington to Richmond, then east through Williamsburg to Newport News and Norfolk met this definition. Also cities outside the corridor, such as Lynchburg, were seen as key locations for a statewide system. On this point, a Bankshares officer said:

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[16] Ibid., p. C-19.

[17] Cf. Appendix (A), pp. A-24-25

> "Bankshares was interested in going into other cities that were not in the corridor in order to become statewide. Yet, we were not interested in picking small country banks, because they do not have growth potential in our opinion, and serve only a very limited area."[18]

This same officer observed that one major system in Virginia was employing a contrasting strategy in that it merged banks throughout the state in rural communities.

> "I don't know what they see in these areas. We have heard them say that they can take a bank and operate it so that it is going to earn so much on total assets. But, we feel we can do the same thing, but we are interested in growth rather than just keeping a small branch that is never going to amount to anything."[19]

<u>Discussion</u>

The expansion of both First and Merchants and Bankshares seems to have been generally consistent with their marketing strategy. As shown on Table C-I, Appendix (C), First and Merchants completed seven mergers during the 1962-1966 period. These mergers gave the bank 33 new banking offices; they provided entry into the twelve new marketing areas shown on Table C-II, Appendix (C).

Bankshares completed the 13 acquisitions shown on Table A-I, Appendix (A) over the period January 1963-1967.

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[18] *Ibid.*, p. A-24.

[19] *Ibid.*, p. A-25.

These acquisitions gave Bankshares 73 offices in the 20 marketing areas shown on Table A-II, Appendix (A).

With few exceptions, the acquisitions of both organizations were growth oriented, in keeping with their strategy. For instance, five metropolitan areas were involved in their expansion programs. Each area had a population growth rate, over the period 1962-1966, exceeding the 9.1 percent for the rest of the state. The growth rate of Washington, D. C.--Virginia part--was 32.5 percent; Richmond 15.2 percent; Norfolk-Portsmouth 14.5 percent; Lynchburg 10.9 percent.[20]

Growth Area Strategy: Growth and Profit Opportunities. Seemingly the plan to merge only banks in high growth areas does not consider some other growth and profit opportunities. First, this strategy if strictly followed excludes banks in low growth areas which have a relatively high return on capital or which have a very low loan to deposit ratio and, therefore, surplus funds for immediate use in high growth or high return areas. Such combinations seem to offer interesting profit opportunities--to an expanding system--which might make a low growth merger attractive. Also, screening acquisitions by area growth potential eliminates the profit opportunities

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[20] Bureau of Population and Economic Research, op.cit., p. 8. "Estimates of the Population of Counties and Cities of Virginia as of July 1, 1966."

from "management induced growth"; where better management might improve profitability or the market share.

<u>Growth Area Strategy</u>: <u>Impact on Competition</u>. Competition in the areas served by First and Merchants, Bankshares, and other expanding systems appears to be increased. For example, no statewide banking system served the Waynesboro, Staunton, Augusta County regional population center in 1961. Furthermore, the largest of the eight banks serving this area, in 1961, had deposits of $15 million.[21] By the end of 1966, Table E-II, Appendix (E) shows that this area was served by branches and affiliates of three banking systems--with system deposits ranging from $301 to $536 million-- and three smaller banks with deposits ranging from $5.8 to $19 million.[22]

The nature of banking competition in many of the areas served by the statewide systems also has changed. This fact is illustrated by the transformation of First National of Waynesboro, a bank with $11 million deposits, into a branch of a bank with over $250 million in deposits, by its 1964 merger with First and Merchants. In such a situation the full resources and wider range of services of a large statewide

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[21] Bureau of Population and Economic Research, "Virginia Banking Survey For Years of 1947, 1961, through 1966," <u>loc.cit</u>.

[22] <u>Ibid</u>.

banking institution--more than four times the combined size of all of the competing banks in the area just the year before--became available in the Waynesboro service area. And, when more than one statewide system serves an area a new type of competition exists--system to system competition, between large full service banking organizations.

While it is sometimes argued that increased concentration from merger and holding company acquisitions lessens rather than increases competition, this does not appear to be the case in Virginia. For example, Table E-II, Appendix (E) shows that all of the metropolitan areas, except Roanoke, are served by three or more systems. Additionally, while concentration of deposits in large banks in Virginia has increased since 1962, Virginia was not among the 17 states which had a concentration ratio over 50 percent in 1965.[23]

<u>Growth Area Strategy</u>: <u>Its Impact on Rural Areas</u>. One result of a growth area expansion strategy is that any service and cost benefits which statewide systems bring to the banking public tend to be limited to the urban markets. The implication of this strategy is that both organizations did not care about becoming "statewide" in a geographic sense. Consequently, this type of expansion strategy takes on the character of "skimming

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[23] Gerald C. Fischer, <u>American Banking Structure</u>, pp. 334-35.

the cream from the top". It tends to maximize growth opportunities for management, but it does not necessarily serve equally well all segments of the banking public. However, since banking facilities are a scarce resource, equal facilities cannot be given to all areas. Therefore, it may be that a "skim the cream off the top" strategy actually serves the public interest since too extensive expansion might waste resources.[24] For instance, an economic planner, in allocating this scarce resource, would likely assign such facilities to the areas where they will most quickly produce the biggest

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[24] United States Congress, House of Representatives, Committee on Banking and Currency, A Study of Selected Banking Services by Bank Size, Structure, and Location, 82nd Congress, 2nd Session (Washington: Government Printing Office, 1952), p. 19. "...those who urge more extensive branching do so on the ground that large systems would open offices in places now served only by small banks and so not as fully serviced as places served by larger banks or their branches. On this, our data indicate that banking services definitely increase with bank size. It follows that services would rise if large banks opened offices in places now served only by small banks. However, this would not necessarily be in the public interest. Inspection of the particular cases where small banks are less apt to provide the service than large ones suggests that usually it is because there is little demand for this service by the customers of the smaller banks. Thus, more extensive branching conceivably at least could result in the rendering of excessive services, i.e., a misallocation or waste of resources. For the principal implication of our data is that small banks as well as larger banks, regardless of size and location, play a useful role in our society. They service "neighborhoods." It would be wasteful for them to provide many services normally offered by other classes of banks. There is no neighborhood demand for the services in question. As a corollary and most importantly, our data indicate that, in general, banking services are provided where a demand for them exists."

results--in this case in Virginia's fast growing industrial and urban areas which are served by First and Merchants and Bankshares.

A negative aspect of the growth area strategy of both organizations is that it appears to be inconsistent with the view of management that merger and holding company affiliation can provide a solution to the problem of management succession in smaller banks. This is because the smaller low growth rural banks that are more likely to have management succession problems are excluded from the merger universe.

Non-metropolitan banks, however, have not been "outside" of the merger and holding company movement in Virginia. Nearly 50 percent of the banks merging other banks in the 1962-1966 period were non-metropolitan banks. Also, other systems such as Virginia National Bank have followed a strategy to acquire banks in rural areas.

V. OTHER ELEMENTS OF EXPANSION STRATEGY

Both managements cited other elements of strategy which were important considerations in their acquisition plans.

Other Elements of First and Merchants' Expansion Strategy

Avoid Dilution of Book Value and Earnings--But Give "Fair Value".[25] A strategy employed by First and Merchants

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[25] Cf. Appendix (C), p. C-20.

was to avoid dilution of book value and earnings in mergers, but to give the merging bank's shareholders "fair value" for their holdings.

Maintain a Flexible Strategy.[26] An officer of First and Merchants saw either a slowdown in the pace of their acquisitions, or a modification of their selective strategy because of: (1) regulatory concern over the size and extent of mergers and holding company acquisitions, and (2) competition for the good banking locations. Here it was implied that First and Merchants management recognized these influences and saw the need for a flexible strategy in the future.

Discussion

Dilution of Book Value and Earnings Per Share (EPS). Clearly, First and Merchants' strategy to avoid dilution of book value and earnings per share is intended to benefit the stockholders as well as management. However, on two occasions since 1962, management has reported to stockholders that earnings were relatively lower as the result of merger activities, i.e., the 1963 and 1965 annual reports to stockholders attributed EPS dilution to additional shares of stock issued in mergers. This experience of First and Merchants seemingly is

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[26] Cf. Appendix (C), pp. C-20-21.

consistent with the findings of one study of mergers in Virginia which concluded that stockholders of banks expanding by merger were not getting the same EPS growth as stockholders of banks not merging:

> "Stockholder interests do not appear to be furthered by the bank mergers that have occurred in New York and Virginia. In fact, earnings per share in Virginia is significantly negatively associated with merger activity, perhaps indicating that there may well be conflict of interest between managers and stockholders, at least in the short run."[27]

But, as found in this study, lower EPS can be explained in part by "start up costs" in a merged organization and the added costs of new and expanded services.[28] Consequently, the long run effect of expansion might work to increase EPS growth relative to banks not expanding by merger.

Flexibility in Expansion Strategy. The "flexibility" aspect of First and Merchants strategy reflects appreciation by management that important external forces were influencing the merger picture in Virginia. For instance, regulatory authorities through denials and policy statements influenced the supply of merger candidates by giving bankers an idea of

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[27] Kalman J. Cohen and Samuel Richardson Reid, op.cit., pp. 240-41.

[28] Cf. Appendix (C), pp. C-12-13.

what size and type of mergers might be approved. Shortly after the 1962 legislation the merger of the Colonial-American National Bank and First National Exchange Bank, both of Roanoke, was denied on the grounds that the former bank should be preserved as the nuclei of further statewide expansion. This action was evidence that merger of two relatively large banks in the same market area in Virginia probably would not be approved. Consequently, management had to be aware of these important "outside" influences when planning expansion strategy.

<u>Other Elements of Bankshares' Expansion Strategy</u>

<u>Bankshares' Strategy was to Acquire a Leading Bank in an Area, if Possible a Bank with Deposits over $10 million.</u>[29] Bankshares wanted to acquire the leading bank in a community, one with deposits over $10 million, if possible. First, Bankshares wanted strong, well run banks in key locations. A Bankshares officer explained:

> "At the outset we were particularly interested in getting the leading bank in a community--one with a good reputation, good management, and one which was well established. We wanted to create a strong group."[30]

While Bankshares was interested in the largest bank in an area, management believed that the Federal Reserve was less

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[29] Cf. Appendix (A), pp. A-25-27.

[30] <u>Ibid</u>., p. A-25.

likely to approve such a combination. However, Bankshares did get the largest bank in Northern Virginia (First and Citizens of Alexandria--$61.8 million in deposits), and the second largest in Richmond (State-Planters--$220.3 million) and the second largest in Newport News (Citizens and Marine Jefferson--$18.9 million) and Lynchburg (First National Trust and Savings--$33.6 million).

A second reason for acquiring a leading bank was to obtain banks which had the staff to operate on their own without day-to-day supervision. Given a choice Bankshares preferred banks over $25 million. An officer explained this as follows:

> "You have more problems with banks under $10 million and have to spend more time working with them. We have a small staff, whereas Virginia Commonwealth and First Virginia operate, by and large, with a large holding company staff. A larger staff allows them to acquire more smaller banks...
>
> In such cases these banks (banks over $10 million) run themselves except for some of the sophisticated services that the holding company can give them, i.e., supplying capital, and helping in taxes, insurance, accounting, purchasing, investment portfolio, and computer applications."[31]

After the initial organization of Bankshares, the size of subsequent acquisitions became a more important consideration

[31] Cf. Appendix (A), pp. A-26-27.

to management. This was because the regulatory authorities were concerned over large bank combinations and Bankshares management believed that acquiring the largest bank in a community would be looked upon as putting the smaller banks at a disadvantage. However, management thought if one of the smaller banks were acquired the chances for approval of the acquisition would be greatly improved.

Bankshares' Acquisition Strategy was to Deal Directly with the Acquired Bank's Management.[32] Bankshares' management thought that an acquisition would not work well for either party without the full cooperation of the management of the bank being acquired. Bankshares made no effort to go around management and talk to the big stockholders, if management happened to be reluctant to join.

Discussion

Bankshares' expansion strategy was clearly influenced by having a small holding company staff, whereas some of the other holding companies operating in Virginia have a large staff. For example, a small staff appears to be more in keeping with Bankshares' philosophy of a participating management organization. A large holding company staff probably would lead to more direct control and less autonomy at the affiliate

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[32]Cf. Appendix (A), p. A-28.

level. Furthermore, the choice of Bankshares' management to operate with a small staff also explains their strategy for acquiring relatively large banks which have management that could operate without daily supervision.

The logic of Bankshares' strategy to work through the management of the bank being acquired appears well founded. Clearly, the support of the incumbent management is needed if Bankshares' objective of independent operations by the affiliate are to be realized. Furthermore, it probably would not be desirable to take on the problem of replacing management in the acquired bank if Bankshares had a comparable opportunity elsewhere, i.e., where management conflict was not an issue and where Bankshares' management could have confidence in the ability of the acquired organization to operate with a minimum of supervision.

However, profit and growth opportunities may exist in banks where management is "cool" toward the acquisition, but the stockholders wish to seek improvements through affiliation. To the extent such situations do exist, it may be desirable to deal directly with the stockholders--in full knowledge of a possible management disposition problem--because of potential profit and growth opportunities in the situation, or possibly to get a key location.

CHAPTER X

THE EXPANSION DECISIONS: LEGAL CONSIDERATIONS

This chapter is concerned with four legal considerations thought to be significant by the managements in their selection of a form of expansion. These include: (1) _de novo_ branching, (2) reserve ratios, (3) boards of directors, and (4) regulation.

I. DE NOVO BRANCHING

The critical issue regarding _de novo_ branching in Virginia concerned the disparity in branching pertaining to a merged system and to a holding company. The managements of both First and Merchants and Bankshares considered that the holding company form enjoys a significant advantage as the result of its greater _de novo_ branching opportunities.

The Position of First and Merchants

De Novo Branching Restrictions Favor the Holding Company.[1] An officer of First and Merchants stated that the _de novo_ branching restriction on a merged system was probably the most valid argument in favor of the holding company form. However, he expressed the hope that this difference would be

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[1] Cf. Appendix (C), p. C-16.

eliminated by legislation which would enable a merged system to branch to the same extent as a holding company.

The impact of the *de novo* branching restriction was illustrated in terms of First and Merchants operations in Lynchburg. Here they obtained six branches by merger with Peoples National Bank and Trust Company, in January 1963. However, no additional *de novo* branches could be established in the area, even though the community will continue to grow. On the other hand, holding company affiliates operating in Lynchburg have been able to branch *de novo* in the area, whenever the need was justified.

To Offset De Novo Branching Restrictions in the Merged Area, First and Merchants Prefers Merger Partners with Branch Offices.[2] First and Merchants' expansion strategy minimizes the *de novo* branching restrictions in the area of the acquisition through merger with a bank which has an already well established branch system.

The Position of Bankshares

The Holding Company has Greater De Novo Branching Opportunities.[3] Bankshares' management preferred the holding company form because the 1962 legislation gave holding companies

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[2] *Ibid.*, pp. C-21-22.

[3] Cf. Appendix (A), pp. A-5-6.

greater _de novo_ branching opportunities than it did to banks expanding by direct merger. A merged system could not establish additional branches in the area of the bank it merged. By the way of contrast, a holding company could acquire a bank as an affiliate and the affiliate, as a separate bank, could continue to _de novo_ branch in its home office area.

Discussion

Clearly, differences in _de novo_ branching provide a holding company with a competitive advantage over a merged system. The literature concerning the Virginia banking scene and the managements of both forms acknowledge this fact. However, this advantage applies only in the Virginia situation since it stems from the state banking code. It is not typical of state legislation elsewhere. Moreover, this advantage applies to the Virginia situation only until such time as the law is changed. However, this probably will not be in the near future, if for no other reason than that the Virginia General Assembly only meets every two years.

The consensus of opinion of the bank officers interviewed indicates that the _de novo_ branching advantage of the holding company is not significant in the short run, although it could become an important factor in the long run, if the legislation is not modified.

Short Run Impact. A merged system can offset _de novo_ branching restrictions by selecting merger partners with well established branch systems. For example, First and Merchants' mergers in Lynchburg and Newport News added six offices in each place, and its merger with The Bank of Virginia Beach added ten. Also, in the initial phase of the merger movement there are greater opportunities than there are likely to be later to execute more than one merger in the same locality. First and Merchants added 14 offices in metropolitan Norfolk by a merger in Virginia Beach and another in Chesapeake. In this manner, good initial coverage was obtained in the new market area. That is, population and industrial growth patterns are generally slow to change, consequently the structure of demand for banking services probably will not be altered in many communities for a number of years.

The Long Run Impact. The alternatives open to a merged system to keep pace with a holding company in growing communities are: (1) additional mergers, (2) formation of a new bank and subsequent merger, and (3) relocation of existing branches. Each of these alternatives, however, is generally less desirable than _de novo_ branching.

Over a period of time opportunities for additional mergers will become less as the number of independent banks decreases and the concentration of the expanding systems increases. Often more than one merger in the same market area

may not be possible where there are only a few acquisition eligible banks and where the elimination of a competing bank increases concentration in the area. For example, the Justice Department, in January 1969, challenged the proposed merger of Virginia National Bank and The Bank of Hampton Roads, alleging the merger would reduce competition in violation of the Clayton Antitrust Act.[4]

Furthermore, mergers in new market areas may not be possible because banks may not be located in the area, and formation of a new bank in anticipation of subsequent merger, or relocation of existing branch offices are typically more costly and less efficient methods of entry than are merger or de novo branching. Thus, the long run expansion opportunities of merged systems are not only likely to decrease, but they are generally more costly than the de novo branching opportunities of the holding company.

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[4] Wall Street Journal, January 21, 1969. "Virginia National Bank, which the suit said is the second-largest in the state, has eight branches in Hampton Roads. It has 42% of total commercial bank deposits in the Hampton Roads area, a larger share than any other bank in the area, the suit said. Virginia National doesn't operate branches in Newport News, which adjoins Hampton Roads, but Virginia National's Hampton branches hold 12% of total commercial bank deposits in the combined Newport News-Hampton Roads area, the suit added.

The Bank of Hampton Roads has one office in Hampton Roads and four in Newport News. It accounts for 8% of the total deposits in both Hampton Roads and in the Newport News-Hampton Roads area, according to the suit.

Virginia National, as of June 29, 1968, had assets of

<u>A Public Benefit Consideration</u>. If the long run disparity in growth opportunities between the two forms becomes a significant competitive factor, merged systems may form holding companies to improve their growth potential.[5] And, if it is true as alleged in the literature and argued by First and Merchants that merged systems are potentially more efficient than holding companies, then the Virginia banking public may face higher cost, less quality, and less extensive banking services in the long run. On the other hand, the situation in Virginia clearly will permit legislators and bankers to assess better the relative merits of each organization, if they are provided equal opportunities for growth, profit, and public service.

II. RESERVE RATIOS

The focus of the reserve ratio issue was on the fact that a holding company, under certain conditions, can gain a lower effective reserve ratio on its total system deposits than can a merged system. Bankshares cited this point as a significant consideration.

$705 million, deposits of $628 million and loans of $412 million.

The Bank of Hampton Roads, as of that date, had assets of $19 million, deposits of $17 million and loans of $12 million."

[5] In forming a holding company it may be possible for a merged system to spin off previous acquisitions as independent affiliated banks.

The Position of Bankshares

Lower System Reserve Requirements for Holding Companies.[6] Bankshares preferred the holding company form because it had an economic advantage in terms of the reserves required against system demand deposits. This advantage, representing higher potential earning power, came from two factors. First, non-member (Federal Reserve System) affiliates continued to operate with 10 percent reserve ratio on demand deposits in lieu of the 12 percent (country bank) or 16 1/2 percent (reserve city bank) ratio required for banks merged into a member of the Federal Reserve System. Bankshares' three non-member banks, in 1964, gained an estimated $640,000 in earning reserves, in Bankshares' view, potentially worth income of approximately $38,400 per year.

Second, each holding company affiliate used the reserve ratio applicable to its own locale. Thus, only affiliates in designated reserve cities needed to apply the higher 16 1/2 percent reserve city ratio, other banks could use 12 percent. By the way of contrast, a merged system with an office in a reserve city was required to apply the 16 1/2 percent ratio to total system deposits, wherever located. By not having the 16 1/2 percent rate required on all affiliates, in 1966,

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[6] Cf. Appendix (A), pp. A-14-15.

Bankshares gained an estimated earning reserves of $46 million, in Bankshares' view, potentially worth some $360,000 income a year, at 6 percent.

Discussion

Clearly lower reserve ratios on demand deposits can be a significant economic advantage for the holding company. For example, the profit opportunities due to differences in reserve ratios on deposits could vary between:

A. A holding company not operating affiliates in Richmond (a reserve city):

-- 10 percent ratio for non-members

-- 12 percent ratio for non-Richmond affiliates.

B. A holding company operating affiliates in Richmond:

-- 10 percent ratio for non-members

-- 12 percent ratio for non-Richmond affiliates.

-- 16 1/2 percent ratio for Richmond affiliates.

C. A merged system without an office in Richmond:

-- 12 percent reserve ratio for the complete system.

D. A merged system with an office in Richmond:

-- 16 1/2 percent reserve ratio for the complete system.

In the outcomes A through D, a holding company generally has a ratio advantage over a merged system. It has an opportunity, in certain cases, to apply lower reserve ratios against system

deposits. That is, a member bank merged system cannot use the lower 10 percent ratio, and a merged system with an office in Richmond must apply the 16 1/2 percent ratio against all system deposits, whereas a holding company with a Richmond affiliate applies the 16 1/2 percent ratio only against the deposits of that affiliate. Consequently, the holding company form has greater profit opportunities, not because of better or more aggressive management, but because of the impact of legislation on earning reserves.

The disparity in earnings opportunities favors the holding company in acquisitions. For example, if a Charlottesville member bank were acquired as an affiliate by a Richmond holding company, the 12 percent ratio would apply to the affiliates' deposits. By way of contrast, if the Charlottesville member bank were acquired by a Richmond merged system as a branch, the 16 1/2 percent ratio would apply. Under these conditions the 4 1/2 percent differential on earning deposits would give the holding company either: (1) "quicker pay back" on its acquisition, or (2) the opportunity to pay higher premiums for the bank with the same "pay back". In either case, the difference in earnings potential gives the holding company a competitive edge in acquiring two of banking's scarce resources--desirable locations and desirable management, or both.

There are several reasons why it is difficult to assess the significance of the unequal earnings opportunities resulting from the ratios applied to demand deposits. First, the

time elapsed since 1962 is not of sufficient duration to identify the possible long-term effects on the competing forms in Virginia. Second, if there were an adverse effect on competition it would be very difficult to lay the cause to the ratio differential and not to other conditions affecting competition, such as: (1) management, (2) markets, (3) customers, (4) services, and (5) organization structure.

Possibly an interim perspective on this issue stems from the fact that the literature does not indicate that academicians, bankers or regulatory authorities have expressed undue concern on this point. Because of this, the problem may be more theoretical than actual.

III. BOARDS OF DIRECTORS

The critical question regarding boards of directors is: "Are honorary boards of directors in a merged system as effective as the legal boards they replaced?" This question arises because holding company affiliates are separate legal entities and, therefore, continue to operate with their own boards of directors and bank officers.

The Position of First and Merchants

Change in Status of the Merged Bank's Board of Directors is a Disadvantage of Expansion by Direct Merger.[7] To replace

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[7] Cf. Appendix (C), pp. C-15-16, 22.

the merged bank's legally constituted board of directors, First and Merchants appointed an area advisory board, using the same group of men. Management found that their experience with advisory boards was especially good because the directors were used as they had been previously. That is, advisory board members were used for their advice and knowledge of the community and its affairs. The only significant difference noted by an officer of First and Merchants was that area advisory board members did not have any real legal liability.

The Position of Bankshares

Local Identity.[8] Bankshares preferred the holding company form because the acquired banks retain their identity and because the bank officers and directors retain full responsibility for the bank's operations. Affiliation did not remove a bank from the local scene. The community continued to deal with the same corporate entity and corporate officers and changes in the service area tended to be minimized since local management and local boards of directors continued to exercise daily supervision of the affiliate's operations. Because of these considerations, an officer of Bankshares offered the opinion that the fundamental philosophy of group banking more nearly meets the test demanded in the compromise

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[8] Cf. Appendix (A), pp. A-12-13.

between Virginia's traditional concept of unit banking and the state's need for larger banking organizations.

In addition, an officer of Bankshares argued that with affiliate directors representing one stockholder, the holding company, there was no accommodation of multi-group stockholders.

> "Most of our banks are 100 percent owned except for directors' qualifying shares. The exception is a very small minority whose basic rights are guaranteed by law. Naturally we safeguard them too for we don't want to go to court. The point is this, where you have basically one stockholder who speaks with one voice, the directors representing the stockholder, who is only one, are naturally more responsive to the stockholder's wishes. Directors do not represent different groups of stockholders with divergent ideas. Also, with only one stockholder is it not natural to be more attentive and responsive to his wishes? After all he owns the bank, lock, stock, and barrel. In a publicly owned corporation you don't have this. Neither do you have a stockholder who advises and counsels the directorate. The stockholder can't be capricious and the directors can't be arbitrary in a holding company set up."[9]

Discussion

A central issue concerning boards of directors in the two forms involves the role and responsibilities of "legal"

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[9] *Ibid.*, A-13.

versus "honorary" members. A question to be answered is: "What are the differences of operating with "honorary" boards versus "legal" boards at the local level?"

"Honorary" Boards of Directors. The discussion of honorary boards, also called Area Advisory Boards and Regional Boards, considers three stages in their evolution. The first is the period immediately following merger when feelings at the local level have to be considered. In this stage the appointment of an honorary board has the "negative" advantage of avoiding ill will for those members of the merged bank's old board who were not appointed to the board of the merging bank. At this time of initial entry into a market area, the continuing "good will" of the previous bank's management could be an important factor in community relations, particularly where the old board members were leaders of the community.

The second stage in the development of an honorary board is the time when the first "new" member has to be appointed, since this action inevitably raises the question whether the board will be perpetuated. Managements decision at this point will probably be based on how effective the honorary board has been in maintaining and generating business. That is, "Have honorary boards 'paid their way' in their advisory role?" In the case of First and Merchants, its "Regional Boards" have been judged to be effective by management.

In addition to new members being appointed to some of its boards, a new board for Richmond was formed.

> "Through their particular knowledge of local conditions and interest in the bank, members of our several Regional Boards have rendered invaluable assistance in promoting the affairs of our various widely separated offices. Recognizing this, and also that the make-up of our Board of Directors is becoming increasingly statewide in character, a new Board for Richmond offices was formed during the year. We look forward to a close association with this group of outstanding men as we do with members of the Leesburg and Virginia Beach Boards, added at the time of our recent mergers."[10]

The third stage in the development of an honorary board involves the "second generation" management, if the boards are perpetuated. In this stage the motivation of second generation directors probably will be different than the first because of differences in the "legal" and "honorary" role in policy development and management control. There will be a natural tendency for management policy development and implementation to fall within the framework of legal responsibility in the corporation, keeping honorary directors in a purely advisory role. Consequently, it may become more difficult to attract and hold the desired quality of persons on honorary boards

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[10] First and Merchants National Bank, 1965 Annual Report, (Richmond, Virginia: First and Merchants National Bank, 1965), p. 16.

because top management talent is less likely to remain in a purely "advisory" capacity.[11] As a result, holding companies might have a long run advantage in competing for the best qualified talent to fill boards at the local level. However, the experiences of both forms in Virginia are not of sufficient duration to evaluate this last stage of "honorary" board evolution.

Legal Boards. Retention of legal boards was one of three reasons given by Bankshares why expansion by the holding company route more nearly meets the test demanded in the compromise between Virginia's traditional concept of unit banking and the state's need for larger banking organizations. The other two reasons were that holding company affiliation does not remove a bank from the local scene and directors of affiliates representing one stockholder, the holding company, give more direct response than directors who have to accommodate multi-group stockholders.

A. In a Holding Company Affiliate the Community Continues to Deal with the Same Corporate Entity and the Same

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[11]The legal aspects of advisory boards also are not completely clear. For example, advisory board members may not have legal responsibility in the same direct manner as before, but they may have comparable moral responsibilities in their areas of influence. Therefore, it seems possible that advisory board members may be subject to conflict of interest suits in the same manner as regular directors.

Corporate Officers. Bankshares argued that changes in the service area are minimized under the holding company form because local management and local boards continue to exercise daily supervision of affiliate operations. This argument appears to imply that local level management and service inevitably change as the result of expansion by direct merger; also that change may not be beneficial to the banking public. These results, however, are not necessarily the case. For example, a merged system--like a holding company--can retain an acquired bank's officers at the local level. In fact, this will clearly be the case where the purpose of the merger was to "buy" good management. The local banking public would deal with the same people, with different titles. And, as suggested by the proponents of direct merger, the officers in a newly acquired branch may retain the same or gain even more operating responsibility than they had before merger. In such situations, the public could benefit, as an example from higher lending limits at the local level.

By the way of contrast, an officer of a large Virginia holding company expressed the opinion that the customer feels that his interest is better served when he deals with the "top man" in a banking organization. He argued, a bank president is the "top man", whereas a branch manager is not. He thought that the customer often assumes, rightly or wrongly, that the president has the authority necessary to solve the customer's

problems, i.e., reference "to the home office" is not required as may be the case in a branch of a merged system.

To assess the foregoing attitude the following question is asked: "To what types of customers and in what types of banks might this attitude be an important factor?" First, in large or medium size banks the typical depositor, checking account or savings account, is not likely to be a customer who would have a problem requiring access to the chief executive. Also, for many borrowers, a loan officer is likely to be the highest officer they would see or desire to see, i.e., for time contracts or small loans. In smaller banks, however, more customers probably like and expect direct contact with the chief executive. Even so, customers requiring access to the president are probably a relatively small percentage of a bank's day-to-day business, although they may be more important profit-wise. Therefore, customer access to the bank president vis-a-vis a branch manager may not be as important as some other factors, such as the ability of <u>any</u> bank officer or employee to promote the feeling of responsive customer service.

Bankshares point-of-view that retention of local control results in a minimum number of changes in the service area seemingly implies that changes may not be in the best interest of the local banking public and that there are no problems of "outside control" in the holding company form. On

this point, it is evident that changes in the local service areas may not be undesirable per se. New and expanded services, after either merger or affiliation, are the generally expected and beneficial results of large system banking. Also, retention of legal directors at the local level does not necessarily avoid the problem of "outside control". For instance, the holding company could exercise "dictatorial" control through appointment of "puppet" boards at the affiliate level. Also, holding companies are open to control of special interest in outside financial centers such as New York, in the same manner as any large corporation whose shares are traded on regional or national markets.

B. Bankshares' Position is that Holding Company Affiliation Does Not Remove a Bank From the Local Scene. It is evident that affiliation vis-a-vis merger "as the best compromise with tradition" is not a matter of principle with holding companies in Virginia. This observation is supported by the fact that holding companies have had affiliates merge a bank in some cases rather than the holding company acquiring the bank as an independent unit. Furthermore, there seems to be little difference between affiliation and merger with regard to possible adverse effects on competition. While it is true that there is one less bank in the state after a merger, both merger and affiliation eliminate a competitor and increase banking concentration. Seemingly, therefore, the result in the eyes of

the "traditional unit banker" of either merger or holding company affiliation would be much the same, i.e., "an independent bank" is replaced by a "system bank".

C. Bankshares' Position is that Holding Company Directors Provide More Direct Response. Clearly, the question of director response and management control is an area where the discussion of "organizational and operational" and "legal" considerations overlap. As concluded in Chapter VII, a distinction needs to be made between the situation where an affiliate is 100 percent owned by the holding company and the situation where there are varying degrees of ownership. Where affiliate ownership is almost 100 percent, as is the case with Bankshares, it appears that the action of affiliate boards can be and would be more responsive to the holding company, than it would be in cases where affiliates are owned substantially less than 100 percent. However, the question of accommodating multi-group stockholders will continue to face holding company management where any minority interest exists at the affiliate level. In fact, some bankers interviewed during the course of this study expressed the opinion that there are no more unattractive securities--from the viewpoint of the stockholder--than a minority interest in a small local bank that is controlled by a holding company. Probably the stockholder has no chance of selling his stock to anyone

except the holding company and this is likely to mean on the holding company's terms. Therefore, the unattractive position of the minority interest in an affiliate appears to make holding company management more vulnerable to charges from the minority. That is, the only avenue for effective minority action may be to sue, whereas in a merged system all stockholders have access to a broader market for disposition of their shares in the event they disagree with management policies or actions. By the way of contrast, problems of a dissident minority do not remain after a merger in Virginia, since an affirmative vote of two-thirds of the merging bank's stock forces the other third to exchange or to accept cash, as applicable.

The legal differences between directors in the two forms definately have control and response implications. These differences can be seen by examining the functions and duties of legal directors as outlined in a publication of the New York Stock Exchange:

> "State laws under which the businesses are incorporated hold boards of directors responsible for the welfare of their companies. Directors are not only trustees of the business, and have a fiduciary relationship to stockholders, but also have a responsibility to the company's employees, its customers, and to the general public, upon whose good will the well-being of the enterprise depends. Failure to take cognizance of the responsibility to each of these four groups can adversely affect the solvency of the corporation.

The laws do not spell out the duties of directors other than that they should manage the affairs of the company, so there are wide variations in the functions actually performed by boards of directors. However, there are seven areas of responsibility that appear to have general acceptance.

1. To establish the basic objectives and broad policies of the corporation.
2. To elect the corporate officers, advise them, approve their actions, and audit their performance.
3. To safeguard and approve changes in the corporate assets (issuance of securities, pledge of assets on loans, declaration of dividends, and conveyance of property).
4. To approve important financial matters (such as budgets, capital appropriations, officers' pay, financial audits) and to see that proper annual and interim reports are given to stockholders.
5. To delegate special powers to others to sign contracts, open bank accounts, sign checks, issue stock, make loans, and such other activities as may require board approval.
6. To maintain, revise, and enforce the corporate charter and by-laws.
7. To perpetuate a sound board through regular elections and the filling of interim vacancies."[12]

The very nature and scope of the legal director's responsibilities makes the functioning of management control

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[12]New York Stock Exchange, The Corporate Director and The Investing Public (New York: The New York Stock Exchange, November 1965), p. 18.

and director response in a holding company significantly different than in a merged system. The development and implementation of policy involves resolution of problems among a number of managements, each equally and legally responsible not only to the stockholders, but also in some measure to employees, customers, and the general public. Consequently, the management process is likely to be more complex than is the case of the merged system, with its single board of directors.

IV. REGULATION

Bankshares cited three points regarding the impact of regulation on the two forms of expansion. One, "flexibility in expansion", was considered an advantage of the holding company form. Two, "Security Exchange Commission Regulations" and "Regulatory Agency Control", were considered disadvantages. First and Merchants did not cite any of these points as significant.

The Position of Bankshares

Flexibility in Expansion.[13] Bankshares preferred the holding company form because it provided greater flexibility in selection of a method of acquisition. For example, a holding

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[13] Cf. Appendix (A), pp. A-9-11.

company could expand by acquisition of a bank as an affiliate of the holding company, or expand by merger of a bank into an affiliate of the holding company. Management felt that this option provided an opportunity to select the most likely route for regulatory approval. In support of this point, it was stated that the opportunity to choose the approval path of least resistance was an important factor in the acquisition of one of Bankshares' affiliates.

A merged system, on the other hand, had the problem of changing its charter from national to state, or visa versa, in order to change the route for regulatory approval. That is, a national bank could become a state member bank and, thereby, change the approval agency from the Federal Reserve to the Comptroller of the Currency. However, an officer of Bankshares stated that merged systems were reluctant to switch charters back and forth just to pick the most likely agency.

The "phantom bank" device was an additional acquisition technique used by Bankshares. Under this method a bank was first established on paper only, in the area where Bankshares wanted to acquire another bank which was already in operation. The purpose was to merge these two banks, the "paper" or "phantom" bank and the operating bank. Merger otherwise would not have been possible unless a holding company affiliate was already operating in the area. The advantages of this method of acquisition were: (1) elimination of minority interest and

exemption from Securities Exchange Commission registration, since acquisition was by merger and not affiliation, and (2) the acquired bank could remain as the continuing organization if it were the surviving bank after merger.[14]

Securities Exchange Commission Regulations.[15] At the time Bankshares was formed, 1962, banking was not subject to such requirements of the Securities Acts, as registration and prospectus requirements, annual and periodic reporting requirements, proxy and financial reporting requirements, and insider trading requirements. With the Securities Acts Amendments of 1964 banking was brought under the Acts so that today banks, for the most part, are subject to the same securities rules as holding companies. However, a difference in administration still remains in that banks do not have to report directly to the SEC since they deal exclusively with their respective regulatory agency for securities regulations, as well as other matters. On the other hand, holding companies report both to the SEC and banking agencies.

Regulatory Agency Control.[16] Bankshares saw duplicity of regulatory control as a disadvantage of the holding company

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[14]Cf. Chapter V, pp. V-43-44 for a more detailed explanation of the "phantom" bank device.

[15]Cf. Appendix (A), pp. A-20-21.

[16]Ibid., pp. A-21-22.

form. For example, a merged system--as a single banking institution-- reports primarily to one supervisory authority for matters pertaining to examinations, branches, and "incidental powers".[17] By the way of contrast, a holding company may have a mixture of state or national, FDIC or non-FDIC, and member or non-member banks. Consequently, a holding company could have all of the regulatory authorities involved in supervision of its various affiliates, as well as the holding company itself being under the supervision of the Federal Reserve System. Under these circumstances, it was the position of Bankshares that the duplicity of regulatory control resulted in minor differences in areas such as capital requirements and loan limits. Thus, policy on these matters was not uniform throughout the system.

Discussion

"Flexibility of Expansion". The holding company has a greater number of ways by which it can acquire a bank. For instance, it can acquire a bank by affiliation or merger.[18] This added flexibility might improve the "odds" of acquisition

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[17]Also, each bank obviously must comply with the applicable regulations of the other regulatory authorities, aside from the areas of specific concern of the supervisory authority with primary cognizance over the bank.

[18]There are various technical differences under the Virginia Stock Corporation Act between merger, consolidation, and acquisition of assets in the sense that tax and other

over the long run by the fact that the holding company is better able to process an acquisition application to the agency with the best "approval record".

First, it is possible that differences in the attitudes of government agencies approving applications for expansion may continue to exist even though the legislative criteria for approval of merger and holding company applications now are substantially the same. Given such future conditions the holding company could select the "most likely route for approval". For example, its application can go via the Comptroller of the Currency, Federal Reserve System or FDIC--whichever has the "best approval odds"--by merging a bank with a national, state-member or non-member Federal Reserve System affiliate, as appropriate. On the other hand, a merged system can process only through its applicable agency, unless the surviving bank changes its charter in order to change the agency reviewing its application.

Flexibility in acquisitions would be important to management <u>only</u> if the "odds of approval" were significantly better at one agency, and if a system were still in the early phase of its expansion program. Probably, however, management

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considerations vary. However, merger, consolidation, and acquisition of assets are considered the same under state and federal laws regulating expansion.

in a holding company or merged system which had reached the planned limit of its expansion would be indifferent to this consideration.

<u>Differences in Regulation</u>. The coverage of this point in the literature is "thin". It is significant that the only source found in the course of this study discussing procedural, legal, and technical differences between holding company and merger expansion was a thesis authored by Lewis B. Flinn, Secretary-Treasurer of United Virginia Bankshares.[19]

A. <u>Procedural Differences</u>. Flinn cites--from the viewpoint of holding company management--several procedural differences which make the holding company route more difficult than direct merger.[20] Among these are the requirements for: (1) public disclosure (where the Federal Reserve Board is the approving agency this would also apply to merger), (2) the possibility of hearings, with their resulting delays and uncertainties, required under Section 4(b) of the Holding Company Act (if the Comptroller of the Currency or the appropriate state agency disapproves the application), and (3) minor differences in application forms. Holding company application

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[19] Flinn, <u>op.cit.</u>, Chapter V.

[20] <u>Ibid</u>.

forms are more exhaustive since the Board requires information for each affiliated bank and not just the system as a whole. Information not required on merger forms includes correspondent bank balances, consumer loans purchased, and municipal securities held.

While Flinn suggests that these procedural differences make the holding company route "more difficult" it is possible that the perspective may be, or should be "more expensive." The marginal cost of these differences is likely to be minimal and holding companies have specialists in their organizations to accommodate the problems they involve.

B. Legal and Technical Differences. Flinn cited certain technical and legal differences which work both to the disadvantage and to the advantage of the holding company.[21] Disadvantages of holding expansion are that affiliation requires the expense of registration with the SEC and affiliation does not eliminate minority interest--there is no minority interest in a merger. Advantages are that the holding company gains flexibility from the fact that it may purchase its own stock for use in acquisitions, and stockholder approval is not needed to acquire new banks or issue new shares.

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[21] *Ibid.*

C. Regulatory Agency Control. The differences in regulatory agency control discussed by Flinn do not appear to be a significant factor in the selection of a method of expansion.[22] However, the one-bank holding company has particular significance to the choice of a form of organization for expansion, and to managements who have already chosen to expand by either of the two forms.[23]

Managements in both forms can elect to form a one-bank holding company. The essential difference under current legislation is that the regulated bank holding company will have to change the multi-bank aspect of its corporate structure and, thereby, give up the benefits management saw when group banking was initially selected as a form of expansion. Consequently, under the current legislation management in a regulated bank

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[22] Ibid.

[23] New York Times, September 18, 1968. The extent of the one-bank holding company movement is illustrated in a tabulation made by M. A. Schapiro and Company, Inc. In 1968, there were 27 one-bank holding companies operating with $50.8 billion in deposits, or 15.8 percent of the $320.3 billion held by the Federal Reserve System's 6,000 members--these 27 banks also held on a capital basis $3.8 billion, or 13 percent of the $29.1 billion total. The significance of this movement is illustrated by the statement of the president of the Bank of America on the subject of their plans to reorganize as a one-bank holding company. "A one-bank holding company presents possibilities for greater participation in a number of profitable activities, particularly overseas. While we have no specific businesses in mind, such activities might include leasing, warehousing, mutual funds, financing land development, travel bureaus and other industries closely related to finance."

holding company cannot elect to have their banking operations in the group form, and at the same time have non-banking operations as a one-bank holding company. Here, a choice will have to be made by management: to weigh the benefits management sees in diversification into non-banking operations against the benefits of group banking. By the way of contrast, management in a merged system can keep their banking operations in the form desired and also diversify into non-banking operations as a one-bank holding company. That is, management in the merged form has "the best of both worlds".

CHAPTER XI

SUMMARY AND CONCLUSIONS

The principal objective of this research was to present information on the two banks studied--First and Merchants, expanding by direct merger; and Bankshares, expanding by the holding company route--with a view toward examining, from the management point-of-view, the relative advantages and disadvantages of direct merger and the holding company as alternative methods of expansion. To accomplish this objective, the research design focussed on the central issues considered by the managements in their decisions to expand. Or, in other words: "How were these issues assessed by the managements in terms of the advantages and disadvantages of one form of organization relative to the other?"

This chapter now restates the developments of the previous chapters and discusses the more important findings and conclusions of the whole study.

I. SUMMARY OF THE HISTORICAL BACKGROUND

The discussion of banking history and changes in the structure of banking in Virginia, during the period 1962-1966, was intended to provide a perspective of the expansion of banks in the state.

A. In the past forty years the state law regulating expansion of banks in Virginia underwent three significant changes. In 1928 bank expansion was curtailed. Mergers were limited to the immediate geographic area of the parent bank and de novo branches to cities having a population of not less than 50,000. In 1948 bank expansion was further curtailed. De novo branches were limited to the immediate area of the parent bank. In 1962 bank expansion was liberalized. De novo branches and mergers continued to be authorized in the immediate area of the parent bank, but mergers were authorized elsewhere in the state.

B. Until 1962, Virginia bankers generally had a negative attitude toward branching. This attitude, in part, derived from concern over the expansion activities of The Bank of Virginia, previously The Morris Plan Bank of Richmond. Other factors which had an effect on bankers' attitudes were the division of the state into separate economic, social, and political regions, and the fact that Virginia bankers, like many bankers elsewhere, were slow in seeing any need to enter the field of consumer finance or other fields that were not "traditional".

C. Ultimately dynamic forces outside and inside the state forced a change of thinking on the part of Virginia bankers and legislators regarding branching. Consequently,

legislation passed in 1962 authorized statewide expansion of banks by direct merger. The significant forces external to Virginia were: (1) the enactment of the Holding Company Act in 1956 and the subsequent rapid expansion of holding companies, (2) the increasing competition from larger banking systems in neighboring states, and (3) the banking industry's development of broadened services for the public, i.e., the evolving concept of a bank as "a department store of finance". Significant forces internal to Virginia were: (1) the accelerated trend toward urbanization and industrialization of Virginia's communities, and (2) the growing competition from holding companies, which were not regulated by state law and which, therefore, could expand into communities throughout the state, while individual banks could not.

D. The changes in the Virginia banking community were the result of forces that bank management, for the most, did not originate and could not control. Bankers, therefore, were not the primary motivating force of innovation in the state.

E. The 1962 legislation authorizing merger on a statewide basis resulted in an "Oklahome Land Rush" of mergers and holding company acquisitions throughout Virginia. Some of the significant changes in the banking structure resulting from this were: (1) fewer banks, but more banking offices, (2) creation of six statewide banking organizations--two merged

systems and four holding companies, (3) greater deposit concentration in the largest banks and banking organizations, (4) accelerated growth of the larger banks in relation to their competitors, permitting development of banking organizations in Virginia large enough to compete with the banking organizations to the north and south of Virginia.

F. The merger and holding company movements resulted in the following beneficial changes: (1) larger lines of bank credit, (2) improved mobility of funds for meeting the credit needs of the several regions throughout the state, (3) more extensive banking services, (4) greater flexibility for banks to serve growing urban communities, (5) broadening of local markets in which Virginia banks compete with each other, and (6) evolution of a new level of banking competition--system to system competition on a statewide basis.

II. SUMMARY OF FINDINGS IN THE AREA OF THE LITERATURE

The literature is strong to the extent that it embodies a comprehensive list of the advantages and disadvantages of the two forms of organizations. Most of these were considered by the managements of First and Merchants and Bankshares in their selection of a method of expansion. The literature, however, is thought to be weak in other respects, and for reasons generally recognized by scholars and bankers, alike.

These weaknesses largely are the result of the imperfect state of research in certain areas.

The literature generally is "thin" in the area of direct and comprehensive comparisons of a merged system and a holding company as alternative forms of expansion. Discussions typically contrast the holding company or merged system to a unit bank, rather than one to the other. Yet, this situation is understandable since, historically, the controversy has been between the desirability of unit banking versus any and all forms of multi-office banking.[1]

The literature tends to cite advantages and disadvantages as "generalizations", in the sense that little attention is given to the question: "To whom is this or that organizational characteristic an advantage or disadvantage?" Issues ordinarily are not examined with a view toward recognizing any differences between the parties at interest, who may be: (1) management, (2) stockholders, (3) depositors, (4) regulatory authorities, (5) borrowers, and (6) the general public. Also, issues typically are not examined with a view toward considering management policy toward: (1) deposits, (2) loans, (3) capital, (4) services, (5) profits, or (6) growth. The importance of this deficiency is that the consideration of different points-of-view alters the significance of a particular advantage or

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[1]Cf. Quotation p. V-1.

disadvantage, depending on the circumstances at hand. For example, an advantage of the holding company is alleged to be that an acquired bank retains its name after affiliation; therefore, it continues to benefit from its "local identity" in its service area. However, this is not a valid generalization because the lack of homogeneity of customers and markets may make a "statewide system identity" the preferred marketing name under certain conditions.

Some of the advantages and disadvantages cited in the literature cannot be resolved clearly in favor of either form because supporting empirical evidence is lacking. For instance, quantitative evidence directly comparing the holding company and the merged system is needed in the areas of: (1) economies of scale and integration, and (2) cost of capital--capital structure.

Other issues cannot be resolved in the favor of either form because they are subjective in nature; consequently, they are not subject to quantitative proof. These issues relate to questions of "management choice or preference", such as centralized versus decentralized control, or the value of "legal" versus "honorary" directors. Furthermore, some advantages or disadvantages tend to change their character over time, after the persons active in management at the time of an acquisition disappear from the scene.

III. SUMMARY OF FINDINGS FROM THE EXAMINATION OF THE EXPANSION EXPERIENCES OF FIRST AND MERCHANTS AND BANKSHARES

Significant findings in various areas are drawn together in the following paragraphs. They are discussed with regard to an explicit set of criteria against which the two forms can be measured: (1) efficiency and profitability, (2) ease of acquisition, (3) management effectiveness, first generation and successor generations, (4) amount of scarce resources needed and ability to acquire and use them, and (5) ability to adapt to a changing environment and technology. The measurement of the two forms against these criteria is not intended to provide the "right answer" or "absolute truth" on the issues and questions considered in this dissertation. Rather, it is intended to provide a framework in which to think about various points. Such perspective is significant since investigation of the expansion experiences of First and Merchants and Bankshares shows that the choice between direct merger and the holding company turns on considerations which are largely particular to a given situation. Therefore, there are generally no "right" or "wrong" answers in the normative sense.

Profitability and Efficiency

It is a conclusion of this study that--in Virginia--the holding company has a clear-cut advantage over the merged system

with regard to profitability. On the other hand, it is a conclusion of this study that the merged system, under certain conditions, is a more efficient form of organization than the holding company. Without question, however, the profitability advantage of the holding company seems to be the most significant of these items.

The Holding Company is Potentially More Profitable. In Virginia, the holding company is potentially more profitable than the merged system because of several advantages resulting from the legal environment. These advantages involve: (1) de novo branching, and (2) reserve ratios. They are a type of "quasi resource" in that they result from legislative factors.

A. De Novo Branching. The holding company has a significant growth advantage as a result of greater opportunities for de novo expansion under the Virginia banking code. A holding company acquiring affiliates located throughout the state attains what is the equivalent of statewide de novo branching privileges. By the way of contrast, a merged system has de novo branching privileges limited to the area of its home office. Clearly, therefore, there is a disparity in growth opportunities between the two forms. The holding company has a clear-cut advantage in the acquisition of "locations" and "management" which are among the scarce resources in banking.

The *de novo* branching advantage of the holding company is probably not significant in the short run since merged systems can acquire banks which already have a well-developed branch system. Holding companies, however, are expected to hold a significant advantage in the long run, unless the branching statutes are changed to provide equal opportunities for expansion. That is to say, if equalizing legislation is not enacted the growth of merged systems will be restricted in a manner similar to that experienced by The Bank of Virginia, as a consequence of the restrictive legislation in 1948. In The Bank of Virginia situation, branch operations were frozen in the urban areas it served apart from its home office, while local banks and holding companies in these areas could expand to capture the fast growing, profitable urban market. Resolution of this issue does not seem possible in the short-term, if for no other reason than the Virginia General Assembly meets only every two years.

B. *Reserve Ratios*. The holding company has the potential for higher earnings because it has an opportunity, in certain cases, to apply lower reserve ratios against system deposits. The significance of this is in the potential for higher earnings, and a resulting financial edge in the competition for good locations or good management. With higher earnings potential, holding company management can, perhaps,

justify paying more for a particular acquisition--than a merged system--and still maintain the same "pay back" and impact on future earnings per share.

The Merged System is the More Efficient Form of Organization. Several theoretical and practical considerations suggest that the merged system may be the more efficient form of organization. First, closer integration of banking operations is possible in the merged form. For instance, certain functions in a holding company cannot be combined; trust accounts and the loan and investment portfolios are examples. Also, the separate corporate entity of holding company affiliates makes integration of some operations and services more difficult than in a merged system. Assuming all other factors are equal, differences such as these seem clearly to give the merged system greater potential for organizational efficiency. However, the lack of banking research, based on empirical data, makes this conclusion less certain than would otherwise be the case.

In practice managements in both forms may centralize or decentralize various functions and responsibilities and establish the amount of autonomy given to management in subordinate levels of the organization. Normally this will be in response to different attitudes and circumstances in the individual situation. Clearly the size, nature and integration

of staff and operating functions at all levels of an organization affect efficiency, regardless of the corporate form. Because of this, the relative efficiency of any one merged system compared to any one holding company is likely to depend on the particular circumstances at hand, even though merged systems, theoretically are the more efficient form of organization. Consequently, the previously discussed legislative factors affecting profitability seem likely to be of greater significance to management than the question of organizational efficiency. This is particularly so in view of the fact that both forms of organization have opportunities for operating efficiency as a function of increased size, regardless of their form of corporate organization.

Ease of Acquisition May Favor the Holding Company

The holding company has a greater number of ways by which it can acquire a bank. For instance, it can acquire a bank by affiliation or merger, whereas a merged system is limited to acquisition by merger. This added flexibility might improve the "odds" of acquisition over the long run by the fact that the holding company is better able to process an acquisition application to the agency with the best "approval record".

However, flexibility of acquisition would be of importance to management only if the "odds of approval" were significantly better at one agency, and if a system were still in

the early phase of its expansion program. Probably, however, management in a holding company or merged system which had reached the planned limits of its expansion would be indifferent to this consideration.

Management Effectiveness

It is evident from the organizations studied that each management believes that there is a direct and important relationship between the corporate form of organization and the resulting effectiveness of management. Issues in this area include questions of organization theory and the role and importance of the formal and informal organization. They involve the attitudes and opinions of management on the relative merits of centralization versus decentralization and local autonomy versus a more direct form of management control. However, because subjective judgements, attitudes and opinions are predominant in discussing these questions, it is difficult to resolve them clearly in favor of either organizational form. Nevertheless, from a management viewpoint certain considerations viewed by themselves lead to significant conclusions.

Policy Development and Implementation and Control of Operations is Easier in the Merged System. A particular style or form of management does not necessarily follow from a particular form of corporate organization. By nature the

holding company is more decentralized and the merged system is more centralized. Apart from the corporate form, however, management in both situations may choose to centralize or decentralize a number of functions and responsibilities, or establish a high degree or a low degree of autonomy at the subordinate levels of the organization, in consonance with management policy.

Aside from the above consideration--it is a conclusion of this study--that policy development, implementation and control of operations is generally easier in the merged system. In this form these matters are internal to one organization; they are formulated by a single policy-making body; they are controlled by a single group of top management. By way of contrast, in the holding company there may be many corporations, many presidents and many boards of directors. Each corporate management is legally responsible for the operations of its own bank.

These organizational differences are commonly thought to make control more difficult in a holding company, particularly where the affiliated banks are not 100 percent owned. Directors and officers of an affiliate are equally responsible to the parent stockholder; to any minority interest, no matter how small; and to the depositors and the community. On questions such as: (1) dividends, (2) rates on up and down stream loans, (3) movement of funds, or (4) allocation of

headquarters costs, resolution in a holding company is clearly not as readily made as in the merged system with its single board of directors.

<u>In the Long Run Boards of Directors of Holding Company Affiliates are Likely to be More Effective than Merged System Area Advisory Boards</u>. Expansion by direct merger permits a choice of retaining a merged bank's board of directors in an advisory capacity, as an Area Advisory Board, or eliminating the use of a board of directors in the area of the merged bank. Expansion by the holding company route involves no such choice, since each affiliate must have its own board. This difference raises the question: "Is an honorary board of directors an effective substitute for a legal board at the local level?"

It is the conclusion of this study that there are several reasons why honorary boards of directors, in the long run, are not likely to be effective substitutes for the legal boards they replaced. These focus on differences between "original actors" and "successor management." Specifically, it is assumed that area boards will be reasonably effective substitutes for the legal boards they replaced so long as the "original actors" remain in their roles as board members, regardless of the obvious differences of legal responsibilities. This hypothesis is based on differences likely to distinguish

original management from successor management. For instance, the role and influence of "founders" in both a holding company and merged system, apart from their positions in the organization, clearly is stronger than successor management, if for no other reason than that they are likely to exercise a significant influence as stockholders. Because of this, "original actors" in their capacity of honorary directors will tend to exercise more influence than will successor management, even though there has been a change in legal responsibility. This conclusion draws a distinction between the "formal" and "informal" organization and underscores that it is likely to change over time.

Over the long run, however, the character and influence of honorary boards seem likely to change. Responsibilities and job status have been altered from an operating role to a purely advisory role. Under such conditions it may be difficult to attract and hold the same quality of man for area boards. First class management talent may not desire to want to accept or want to remain in a purely advisory role. Consequently, if merged systems find it difficult to replace "original actors" with management of the same qualifications and interests, then successor area boards are not likely to be as effective as the legal boards they replaced.

The potential consequences of this consideration on the operations of merged systems in Virginia is not evident at

this point in time. Moreover, it will be difficult to evaluate in the future because this is not a question that is subject to "quantitative" investigation or measurement.

Amount of Scarce Resources Needed and the Ability to Acquire and Employ These. Scarce resources are discussed in terms of management, capital and locations. Certain characteristics of the two forms suggest differences in the amount and type of scarce resources they require.

A. The Merged System May be Able to Operate with Fewer Management Personnel and in Some Circumstances with Personnel Having a Lesser Order of Skills. Two considerations suggest that the merged form may be more economical than the holding company in the utilization of management. First, the merged system is likely to require a lesser order of skills at the branch level, than if the branch were operated as a separate affiliate. For example, this study discussed the attitude that the complexity of the typical branch manager's job is not as great as a bank president's, who has to deal with his own board of directors and who has to build the reputation of his own bank. Also, the merged form is likely to require fewer numbers of management where merger may result in the elimination of officers and employees for functions that can be combined in the merged system which cannot be combined in the holding company; or where an affiliate, as

contrasted to a branch, tends to need a full complement of officers because of its status as a separate corporation.

However, the numbers and skills of management and employees is another function which is dependent on how a particular management wants to organize and manage the organization. Clearly, a merged system which is decentralized and which is managed with a high degree of local autonomy may require more management with a higher order of skills, than a holding company of similar size which is centralized and which is controlled directly from the parent level. Therefore, a generalization that merged systems may make better utilization of management talent is limited by the assumption that all other factors apart from the form of corporate organization are equal.

B. The Holding Company May Have a Lower Cost of Capital in the Long Run. The holding company has an advantage over the merged system in raising capital and using leverage, for several reasons. These reasons are that: (1) a bank has a limit on the amount of debentures of 100 percent on capital stock plus 50 percent of surplus, whereas a holding company has no such limitation, (2) a bank is required to count short-term notes, less than one year, as a liability requiring reserves, whereas a holding company has no such requirement, and (3) a holding company can raise debt and equity in two

ways: by the affiliated banks or by the holding company, whereas a bank is limited to one way of raising debt and equity. However, no data exist which conclusively point to tangible economic benefits for the holding company as the result of these differences, such as a lower cost of capital. Presumably, though, added flexibility in raising and using capital is a benefit which potentially could result in a lower cost of capital over the long run.

C. The Merged System May Have Greater Credit and Funds Mobility. The question of comparative funds mobility cannot be clearly reconciled by "hard data" from the literature or this study. However, there is one factor which theoretically if not practically is a constraint on mobility of funds in a holding company. This factor is the role of the directors of an affiliate, particularly where there is a minority interest. Directors are charged with the legal responsibility for the operation of the bank and this transcends any credit policies or participation agreements of the holding company. Clearly, the possibility of many affiliates with their boards do not provide for the same ease of resolution of matters relating to mobility of funds, or for that matter, dividends, investments, and the many other issues that affect the profitability and operations of an individual bank.

D. <u>The Holding Company Has a Definite Long Run Advantage in the Acquisition of Locations</u>. In Virginia, under the present statutes, the holding company has a significant advantage over the merged system in <u>where</u> acquisitions can be made because of their greater <u>de novo</u> branching opportunities; in <u>how</u> acquisitions can be made because they can choose either to acquire a bank as an affiliate or merge the bank into an affiliate, depending on the individual circumstances at hand; and in the <u>cost</u> of the acquisitions because of lower reserve ratios in some situations. Furthermore, the holding company has an advantage by way of greater flexibility in choosing the type of identification it desires for its banks. It can choose to have affiliates retain the name used before acquisition for "local identity"; or change the bank name to clearly identify the affiliate with the holding company for a "system identity"; or use some combination of system and local identity as service area conditions dictate.[2] On the other hand, a merged system has less identification flexibility since all branch offices carry the home office

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[2] <u>Richmond Times Dispatch</u>, November 5, 1968. A combination of local and system identification was adopted for the first time in Virginia, in 1968, by First Virginia Bankshares Corporation when they renamed their Cambria Bank of Christiansburg as the First Virginia Bank of the Southwest. According to the president of First Virginia Bankshares their other banks would be renamed as local conditions, such as expansion and mergers, dictate.

name. However, identity is dependent on the customers and markets served and the competition in a given area. As an example, customer and service area characteristics may make a "system identity" more desirable in some situations and "local identity" more desirable in others. Under these conditions, a merged system would not be at a disadvantage to a holding company in markets where a "system" marketing image is the preferred identity. Consequently, it is not possible to generalize about all merged systems and all holding companies because of the influence of markets and customers in each individual case.

Ability to Adapt to Changing Environment and Technology. This is the last criterion against which the holding company and direct merger are measured. In one respect it is the most important evaluation for it views the significant differences between the two forms in terms of the future. That is, it examines each form of expansion in terms of the ability of the form to accommodate to changes in environment and technology.

Summarizing, the holding company in Virginia has greater profit and growth potential, and service opportunities than the merged system. On the other hand, development and implementation of policy and control of operations seemingly is easier in the merged form and this form is theoretically more

efficient from the standpoint of integration of operations. The question now becomes: "How do these fundamental differences affect the capabilities of each form to adapt to changes in environment and technology?"

A. The Holding Company: Environmental and Technological Change. The holding company certainly has an edge over the merged system in meeting the challenge of a changing environment and technology, as the result of its greater profit and growth potential. A case in point is the "computer revolution" where high costs and uncertain, but significant rewards faced firms making an early entry into this field. Typically in this type of environment the big, financially strong companies can afford to be leaders by accepting the risk and profiting from the rewards; the less financially strong become followers; the small and weak may not benefit from new technology at all. Placing this point in perspective, the revolution of change in the banking industry has just begun; future change is likely to be rapid and far reaching; innovation is likely to become very important to success, as banking moves toward the "checkless society". Consequently, the holding company in Virginia may be in a stronger position than the merged system when accepting the risks inherent in change and innovation.

However, this advantage of the holding company is "artificial". It could disappear at any time since it results from legal

circumstances--apart from the form of organization--which can be and may be changed to give competing banking systems the same economic opportunities.

B. The Merged System and Environmental and Technological Change. The merged system has an edge on the holding company in that development and implementation of policy and control of operations is easier. Also, the merged form is potentially more efficient from the standpoint of integration of operations. Because of the first advantage, seemingly the merged form can respond to changes and the challenges of innovation more readily than the holding company. It is not burdened with the administrative complexity of separate corporations and problems involving accommodation among many managements. Consequently, decision-making is likely to be quicker and policy implementation easier. This advantage is particularly significant in an environment where the rate of change is increasing and where the ability to rapidly respond to a situation could be important to the future of the firm, i.e., witness Ford's Mustang; IBM's 360 computer series.

The merged form advantage of greater organizational efficiency is significantly different from holding company advantage of greater profit and growth opportunities. The former is not an "artificial" advantage, the latter is. Given equal opportunities under law, the potentially greater efficiency of the merged form may tip profitability in its favor.

In the event profit and growth opportunities are equalized--thus eliminating the economic advantage of the holding company--then the merged system may become the more viable form of banking organization in Virginia.[3] In this lies the challenge to the banker and legislator in Virginia: create a truly competitive environment where the holding company and merged system operate on an equal footing, and let the forces of competition point to the most efficient form of banking organization, if there be just one.

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[3]Evidence supporting this conclusion appears to be the action by First Virginia Bankshares, Corporation--reported in the Washington Post, January 30, 1969--whereby this holding company plans to consolidate three large affiliates in the Northern Virginia (Washington Metropolitan) area. In this situation the surviving bank is a state non-member with a home office in Fairfax County. With the exception of *de novo* branching into Arlington County--where a branch system already exists--the new bank could *de novo* branch in all of the other cities and counties previously open to the three affiliates. Consequently, the growth opportunities of the newly merged bank are essentially the same as the three independent affiliates.

But, by having the surviving bank as a state non-member the lower 10 percent reserve ratio for state non-members applies to the combined deposits of the three banks. Consequently, First Virginia gains approximately $587,500 in demand deposits available for loans and investments, worth approximately $41,250 in pre-tax earnings, if invested at 6 percent--computed on the differential between the state non-member ratio and non-reserve city ratio of 12 percent, on the first $5 million demand deposits and 12 1/2 percent, on demand deposits over $5 million.

Seemingly, this decision reflects the "best of two worlds". First Virginia gains the organizational advantages of a merged system, and at the same time the profit advantage from the lower reserve ratio which generally favors the holding company form.

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APPENDIX A

UNITED VIRGINIA BANKSHARES INC.

I. PURPOSE

This material was collected in connection with a study of two banking systems in Virginia which chose different methods of expanding their banking operations on a statewide basis, as a result of the enactment of liberalized branching legislation in 1962. It is based on interviews with Mr. Lewis B. Flinn, Jr., Secretary and Treasurer of United Virginia Bankshares Inc., of Richmond, Virginia. The information is presented in the form of paraphrased text and direct quotes. It contains no opinion, editorial comment, or analysis by the researcher.

This part of the study concerns the experiences of United Virginia Bankshares Inc. (hereafter called Bankshares) which chose to expand by the holding company route as opposed to direct merger. The focus of this information is on: (1) the central issues in management's selection of the most appropriate form of expansion, i.e., the significant characteristics considered by Bankshares to be advantages of expansion via the holding company, as contrasted to or different from expansion by merger, and (2) significant factors in Bankshares expansion strategy.

Case prepared, 1968, by Paul L. Foster, doctoral candidate.

II. BACKGROUND

The passage by the Virginia General Assembly of the Buck-Holland Bill in 1962 gave Virginia banks significantly greater opportunities for expansion. After the 1962 legislation, statewide expansion could be undertaken by: (1) holding company affiliation, (2) merger, or (3) a combination of the two. Before that time holding company affiliation had been the only alternative available for expanding banking operations beyond the general locality of a bank's home office.

Mr. Lewis B. Flinn, Jr., Secretary and Treasurer of Bankshares explained that State-Planters Bank of Commerce and Trusts, Richmond, (the lead bank in United Virginia Bankshares) was one of the large Richmond banks interested in expansion. As early as 1958 the president of State-Planters, then Mr. J. Harvie Wilkinson, Jr., had considered the concept of formation of a holding company with other large Virginia banks. This was seen as a combination which would improve the competitive position of each of the banks concerned regardless of any subsequent action by the state legislators to relax the highly restrictive branching laws. However, as Flinn explained, "the plan never got off the ground, i.e., never got beyond the conceptual stage."

In 1961, after the earlier efforts had failed to put together a holding company, State-Planters started to consider

other alternatives. Flinn explained, "We started looking elsewhere and talking to other banks. During this time the Virginia Metropolitan Plan was conceived by three large banks in Richmond--that was in 1961--holding company plans were stopped for a while." State-Planters, First and Merchants, and Central National Bank, the three prime correspondent banks in the state, worked hard to sell the Virginia Metropolitan Plan, a de novo branching and merger scheme for banks in metropolitan areas. The plan was proposed to bankers just before the June, 1961 meeting of the Virginia Bankers Association. Its sponsors had hoped the plan would be recommended and brought up in the General Assembly in the winter of 1962. However, according to Flinn, the plan was not accepted, probably because it was sponsored by the big banks in Richmond.

After the Virginia Metropolitan Plan failed to gather the support of the state's bankers, Bankshares' management felt that there would be no changes to the branching laws for another two years, until the 1964 General Assembly.

> "We started again to probe other banks to form a holding company but couldn't get anything moving until out of the blue (we hadn't talked with them) First & Citizens came down and said let's form a holding company. This was in the latter part of 1961, and by early 1962 we had collected a group of six banks.
>
> We knew of the Buck-Holland legislation before we filed with the Securities Exchange Commission to form

> United Virginia Bankshares in June, 1962. Therefore, we had the opportunity to drop it and go the merger route if we wanted. But all of the parties had been sold on, and they liked the idea of forming a holding company where everybody would have something to say; we were building something together; all parties were participants. The local autonomy aspect was important, too. No proposal was made to try to force through the merger route. The feeling was just so strong that this was what we wanted to do, that this is the way we went."

III. IDENTIFICATION AND DISCUSSION OF THE FACTORS CONSIDERED BY BANKSHARES IN THEIR DECISION TO EXPAND VIA THE HOLDING COMPANY ROUTE

Advantages of Expansion by Holding Company

Flinn cited eight significant characteristics which were considered by management to be advantages of expansion by holding company as contrasted to or different from expansion by direct merger; and five characteristics considered to be advantages not exclusive to the holding company vis-a-vis direct merger, but rather contrasted to a local bank in Virginia. These factors are summarized below.[1]

Advantages as contrasted to direct merger:

-- Greater *de novo* branching opportunities.

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[1]The ordering of the factors does not connote priority or weight assigned by management.

-- The holding company form can be equally as efficient as the merged form.

-- Flexibility in raising capital.

-- Greater flexibility in expansion.

-- Local autonomy for acquired affiliates.

-- Local identity of the affiliate is maintained.

-- Decentralized decision-making offers more management flexibility and opportunity than in the typical branch system.

-- Non-member (Federal Reserve System) banks retain their lower 10 percent state reserve requirements when they become holding company affiliates; and only holding company affiliates (members of Federal Reserve System) in reserve cities are required to use the 16 1/2 percent reserve rate. Other affiliates use 12 percent.

Advantages as contrasted to a local bank:

-- Increased organization size improves ability to attract and train management personnel.

-- Affiliation provides a solution to a management succession problem.

-- Affiliation offers economic benefits to the acquired bank stockholders.

-- Credit and funds mobility.

-- New services.

The Eight Characteristics Considered by Bankshares' Management to be Advantages of the Holding Company as Contrasted to or Different From Direct Merger

Holding company expansion offers greater de novo branching opportunities. Flinn explained that the Virginia

banking code limits _de novo_ branching to the immediate geographic area of a bank's home office. For example, he pointed out that a Richmond bank merging in another city cannot establish any more branches in that city after the merger because Richmond was the home office of the merged bank. On the other hand, a holding company can acquire an affiliate and the affiliate can continue to branch since it remains as a legal entity, a separate bank, even though it is a member of a holding company. According to Flinn, this disparity in _de novo_ branching opportunities is not an over-whelming advantage in the short-term. He did think, however, that it could be quite a decisive advantage in the long-term. Further, he speculated that there is going to be pressure applied by those banks following the merger route to change the state banking code to give merged systems the same _de novo_ branching freedom that holding companies now have.

The holding company form can be equally as efficient as the merged form. In support of this point, Flinn said that both the holding company and merged system share many of the advantages attributed to larger banking units: (1) centralization of support functions; for example, purchasing of supplies and system advertising, and (2) use of specialists for trust, legal, tax, accounting, data processing, and other services. Flinn continued:

> "My feeling is that selection of an organizational form will in time (perhaps not initially) be primarily a matter of economics. That is to say initially the selection of an organization form may be based on evaluation of factors (i.e., legislative) then existing, but in the final analysis the choice will be proven out by economics. For example, if a holding company cannot operate just as effectively and efficiently as a branch system, then there is no reason not to make the holding company one merged institution (assuming this is feasible as it is in Virginia)."

According to Flinn, the experiences of Bankshares, and the growth of holding companies in Virginia and elsewhere suggest that the holding company form is generally competitive with merged systems, or if not there are other factors which tend to offset any operational inefficiencies--for example in Virginia, the *de novo* branching advantage.

Holding companies have greater flexibility in raising capital. Flinn illustrated this point by saying that Bankshares can finance either at the bank level or at the holding company level. He added that an important benefit of financing at the holding company level is that capital can be raised more cheaply than at the affiliate level.

Flinn continued:

> "The potential of the holding company is to maximize leverage, using debt financing to a greater extent than through a bank. After all the examiners who examine

> banks are going to be more restrictive on how much debt they are going to allow a bank to issue. They would not have the same concern about a holding company since we do not have any depositors. It is a different thing if we go under. If we fail it has nothing to do with the banks. We are just the stockholder. The stockholder can go broke, but the bank is still in operation."

In addition, Flinn said that a holding company can raise money in a way a bank can not. For instance, a state bank in Virginia (this happened to State-Planters) cannot issue stock except under stock options, or in a sale for cash or to another bank's stockholders in a merger. State-Planters Bank, he said, wanted to acquire land for a building and the party that owned the land wanted a tax-free transaction. The bank could not give him their stock, as such transactions were prohibited. So he was given holding company stock, and it was a tax-free exchange, i.e., property for property. "This is one example," Flinn said, "of how a holding company has more flexibility." In addition, he indicated some other ways that holding companies can finance with more ease than a bank. For example, a holding company can issue convertible debentures, preferred stock, and short-term debt and commercial paper in 30 - 100 day maturities.

He continued by saying:

> "We could issue short-term debt at a rate we wanted and that the market

> would permit. If a bank tried to do the same thing there would probably be a limitation on the rate. If the debt instrument was construed as a deposit by the Federal Reserve Board then it would be subject to reserve requirements and to the rate limitations of regulations Q. I don't think any holding company yet has maximized the possibilities. But every now and then you see where somebody has used one."

Greater flexibility in expansion. Two factors were cited by Flinn which provide holding companies in Virginia with more flexibility in expansion: (1) expansion can be by either acquisition of a bank as an affiliate of the holding company, or by merger of a bank into an affiliate of the holding company, and (2) the option to either acquire or merge provides an opportunity for holding company management to select the most likely route for regulatory authority approval of the planned expansion. Continuing on these points, Flinn observed that the holding company has the opportunity to choose the method which has the best chance of regulatory agency approval. On the other hand, merged systems would have the problem of changing their charter from national to state, or vice versa, if they wanted to change the route for approval. He felt that many merged systems would be reluctant to switch charters back and forth just to pick the most likely path for approval of their application for merger. For this reason, Bankshares has an advantage of added flexibility in routing applications. In addition, he felt that the

opportunity to choose the course of least resistance was an important factor in their acquisition of the Seaboard Citizens Bank of Norfolk.[2] Lastly, Flinn discussed one other method of acquisition open to holding companies not open to merged systems. This is the "phantom bank" device, which he stated no one else in Virginia, to the best of his knowledge, has used. In describing Bankshares use of this device for the first time he stated:

> "We set up a shell corporation, the phantom, under the title of a bank, nominally capitalized, to exist on paper only. The scheme is that the existing bank will merge into this shell corporation--this phantom. Application was made to the Federal Reserve Board to acquire this phantom, and in this particular case, we also applied to the Board for permission for this phantom to merge with an existing bank. There were two applications but for one purpose--to acquire a bank in Williamsburg. With an exchange offer, which is the more normal route, stockholders have the option of taking it or leaving it, and usually you end up with some minority interest. These are not necessarily people who want no part of the deal, but some were dead, traveling, unlocatable, and so forth."

Since the phantom bank technique is processed as a merger it has two advantages. First, it eliminates minority

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[2] Seaboard Citizens Bank of Norfolk was acquired as an affiliate in January 1967 through consolidation with Merchants and Farmers Bank of Franklin which had been previously acquired as an affiliate in January 1963.

interest. Second, stock issued in exchange for the acquisition is exempt from Securities Exchange Commission registration, and this is a substantial cost savings in comparison to an exchange offer.

Local autonomy for acquired affiliates. Flinn stressed that local autonomy of affiliates of Bankshares has two tangible benefits. First, Bankshares was intended from the start to be a joint effort or partnership affair. Each of the original partners was represented on Bankshares' board of directors and, therefore, had a say in the policies of the organization. In addition, while each new joining bank was not necessarily to be represented on Bankshares' board, it was planned to have a committee of presidents which would set the policies for the type of services which the holding company would give to affiliates. In this way, Flinn continued, the holding company form of organization, which is decentralized by nature, was ideally suited for implementation of Bankshares' participating management philosophy.

> "We try to get together at least once a month with the presidents committee and talk about problems, policies, and new services that Bankshares should provide. Thus, we have a joint effort: (1) to become a statewide organization, (2) to build a larger organization in order to make bigger loans to Virginia businesses, (3) to extend new services throughout the system, and (4) by pooling resources to provide special services,

> such as in the computer area, of a quality which no one bank could afford."

Second, Flinn said that local autonomy for affiliates, coupled with a participating management philosophy at the holding company level, was an important factor in attracting new member banks to the Bankshares organization. According to Flinn, there were some banks which would not join a merged system because the presidency of the merged bank would be eliminated. In addition some of these same bankers would not join a holding company unless they were assured that there was, in fact, local autonomy at the operating level. Flinn said that it is hard to convince some bankers interested in joining the holding company because they don't believe what is said about Bankshares' method of operations--they have talked to someone else who went with another holding company, and they have heard discouraging things. "All holding companies are different", Flinn continued. "We feel that local autonomy and our management philosophy is a very important aspect in attracting banks to our enterprise."

Local identity of the affiliate is maintained. According to Flinn the fundamental philosophy of group banking more nearly meets the test demanded in the compromise between Virginia's traditional concept of unit banking and the state's need for larger banking organizations. Holding company

affiliation does not remove a bank from the local scene. The community continues to deal with the same corporate entity and corporate officers. Flinn believes that this tends to minimize any changes in the bank's service area since local management and local boards of directors continue to exercise daily supervision of the affiliates operations. The bank's officers and directors retain full responsibility (actually and legally) for the bank's operation.

In addition, Flinn believes that with directors representing one stockholder (the holding company) there is likely to be more directed response from directors of affiliates, i.e., no accommodation of multi-group stockholders is needed:

> "Most of our banks are 100 percent owned except for directors' qualifying shares. The exception is a very small minority whose ~~who's~~ basic rights are guaranteed by law. Naturally we safeguard them too for we don't want to go to court. The point is this, where you have basically one stockholder who speaks with one voice, the directors representing the stockholder, who is only one, are naturally more responsive to the stockholder's wishes. Directors do not represent different groups of stockholders with divergent ideas. Also, with only one stockholder is it not natural to be more attentive and responsive to his wishes? After all he owns the bank, lock, stock and barrel. In a publicly owned corporation you don't have this. Neither do you have a stockholder who advises and counsels the directorate. The stockholder can't be capricious and the directors can't be arbitrary in a holding company set up."

Decentralized decision-making offers more flexibility and opportunity than the typical branch system. Flinn stressed this aspect of holding company operations because it was inherently more attractive to management personnel, and it offered a better environment for developing successor management talent within the industry. Thus, he said that the holding company form appeared to provide the better solution to the problem of successor management.

The unique aspect of the decentralized management concept in holding companies, Flinn pointed out, is the legal status of each affiliate's board of directors. This legal status of constituent bank directors is a very real force in promoting and maintaining decentralization of management.

Holding company non-member (Federal Reserve System) banks retain their lower 10 percent state reserve requirements and only holding company member affiliates (members Federal Reserve System) in reserve cities are required to use the 16 1/2 percent rate--other member affiliates use12 1/2 percent. An economic advantage pointed out by Flinn was that non-member holding company affiliates continued to operate with 10 percent reserve requirements on demand deposits in lieu of the 12 percent (country bank) or 16 1/2 percent (reserve city bank) if they were merged into a bank which was a member of the Federal Reserve System. This advantage to

Bankshares' three non-member banks in 1964 was estimated as $640,000 in reserves, potentially worth some $38,400 in income.

Flinn pointed out that each holding company affiliate was required to use the reserve rate applicable to its own locale. Thus, only those affiliates headquartered in offically designated "reserve" cities need to apply the higher 16 1/2 percent reserve city rate. The other member banks could use the 12 percent country bank rate. On the other hand, a merged system with an office, not necessarily the head office, in a reserve city was required to apply the 16 1/2 percent rate to the entire bank regardless of the bank's various office locations. In 1966 this advantage to Bankshares was reported as being worth, potentially, $360,000 in income a year (at 6 percent), i.e., if the 16 1/2 percent rate were required on all affiliates, as in a merged system with an office in Richmond, additional reserves of $6 million would have been required.

<u>The Five Characteristics Considered by Bankshares' Management to be Advantages of both the Holding Company and Direct Merger as Contrasted to a Local Bank in Virginia</u>

<u>Increased organization size improves the ability to attract and train management personnel</u>. One benefit seen by Bankshares was that through increased size a holding company

could better compete in the labor market for executive talent and have the staff and organization to undertake training programs to help speed the development of personnel entering the banking industry for the first time. As Flinn explained, the holding company form has two things to offer which are generally sought by the young executive. First, it has a large decentralized organizational structure which has more top executive positions than a comparable sized branch organization, i.e., each member bank has a president. Second, larger organizations generally can afford to offer training and employee benefits that are superior to those provided by small banks.

Affiliation with a holding company is a solution to the management succession problem. Flinn illustrated this point by saying that most of the banks that approached Bankshares on an unsolicited basis had management problems, i.e., top management was nearing retirement age, and there was no one underneath who could capably continue the operation. According to Flinn, three banks that had joined Bankshares had a management succession problem. Affiliation was described as a practical solution to the problem since the holding company could provide capable management. In each of these three cases the holding company provided a new president from within the system.

Affiliation can result in economic benefits to the acquired bank's stockholders. Flinn said that the monetary aspect was considered as important and, in some cases, a decisive influence in acquisitions. He illustrated this situation by pointing out that Bankshares' acquisition policy was to acquire affiliates, wherever possible, on a book value basis, i.e., Bankshares' book versus the acquired bank's book.[3] Most of Bankshares' acquisitions have been on this basis. The economic benefit to the affiliate's stockholders resulted from the fact that the stock of many small banks in Virginia generally sold below or at book value, while the holding company generally sold above book and had been as high as 200 percent of book value. He said:

> "Assume you are a large holding company or a large bank and your stock is selling at a substantial price above book. You can afford to offer somebody book for book and at the same time give him, say 100 percent appreciation on what he can get for his stock on the market. One day he has stock certificates worth $100 and just by joining you in a merger or holding company his stock is immediately worth $200. It is hard to gauge the influence that this has, but it is important. It may be the real clincher. We also talk to management about local autonomy, tell them how we operate, etc. We tell them the two or three

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[3]Stated stockholders' equity adjusted to reflect current valuation of assets.

> requirements that you have to hammer on: (1) that their board is responsible for running the show, (2) that Bankshares as a stockholder is basically a service organization, (3) that we are interested in doing bigger and grander things and most importantly to earn some money for our stockholders. But, who knows really how much impact philosophy has versus the dollar?"

According to Flinn, this profit opportunity is less likely to develop today. With all the bank acquisition activity in Virginia some small bank stocks have appreciated in price, eliminating the dramatic profit of four or five years ago. Some stockbrokers have been buying up small bank stocks because they felt that they were a likely merger candidate or holding company partner, and this has pushed the stock price up. So while there may be an exchange premium in some acquisitions today there are not the tremendous profits of the earlier years. This is more likely to be the case for the smaller banks with management succession problems because according to Flinn, it is difficult to get capable management for banks with offices located in small rural areas.

<u>Credit and funds mobility is an advantage of the holding company</u>. As explained by Flinn, holding companies, like merged systems, have the capability of pooling lending resources among affiliates to serve the growing credit requirements of industry. To facilitate the flow of funds throughout their system, Bankshares had developed a loan participation

procedure and encouraged its banks to pre-clear large loans that need to be shared throughout the system. It was Flinn's opinion that the use of rapid communication devices, central credit files and charge cards, plus the efficient use of data processing equipment will ultimately remove any advantages branch systems now enjoyed in the area of credit mobility.

New services. Flinn stated that the holding company could provide a greater range and depth of banking services to the Virginia citizens than a typical unit bank. In addition, the quality of the banking services could be improved. He explained both of these benefits stemmed from the ability of the holding company to employ specialists in areas such as trusts, industrial accounts, and data processing. Examples of the expanded services of Bankshares in the 1962-1966 period were: (1) Municipal Bond Department, (2) special consultants for women, (3) Public Funds Section, (4) Professional Services Program, (5) College Tuition Loan Program, (6) Computerized Payroll Services Program, (7) One Check Payroll Program, (8) Marketing Department, and (9) a credit card program presently in the planning stage.

Flinn recognized that merged systems also are capable of providing expanded services. He continued:

> "A direct comparison, however, of holding companies and merged systems is difficult. This would depend on the

> service objectives of management and the needs of each market area. For example, First Virginia, operating primarily in Northern Virginia, emphasizes consumer business. Therefore, their service structure would be quite different from, say, First and Merchants, operating largely in the Central and Tidewater Virginia areas, which caters, in a fairly balanced manner, to both consumer and industrial accounts."

Disadvantages of Expansion by Holding Company

Flinn stated that there were only a few arguments in favor of the merged form of expansion that were considered by the founders of Bankshares in selecting the holding company route. These factors are summarized below.

-- Securities and Exchange Commission regulations.

-- More complex multiple corporate organization.

-- Subject to regulations of more than one Federal Supervisory Authority.

-- Lack of a single corporate image in the marketing context.

Securities and Exchange Commission regulation. Flinn explained that at the time Bankshares was formed banking was not subject to the requirements of the Securities Acts, e.g., registration and prospectus requirements, annual and periodic reporting requirements, proxy and financial reporting requirements, and insider trading requirements. With the Securities Acts Amendments of 1964, banking was brought under the Acts so that today banks, for the most part, are subject to the

same securities rules as holding companies, and what differences that exist are narrowing. The disadvantage Flinn pointed out was that banks still deal exclusively with their respective regulatory agency for securities regulations as well as other matters, whereas holding companies report to the Securities Exchange Commission as well as banking agencies.

More complex multiple corporate organization. In discussing this factor, Flinn explained that the merged form has the advantage of having the most simple corporate structure, i.e., one board of directors and one senior group of management for one corporation. This type of structure simplifies policy formulation and execution. Examples of the types of problems which can be more easily avoided in the merged form are: (1) diffused authority, (2) internal conflict at the management level, and (3) administrative complications, i.e., separate records for each affiliate. However, Flinn said that these disadvantages can be overcome because the range of management control open to a holding company can be used to achieve the same general results as under the merged form. Further, the administrative problems of the more complex corporate organization of the holding company are offset by other advantages of the holding company form previously discussed.

Subject to regulations of more than one Federal Supervisory Authority. Flinn saw this as a complicating factor,

because supervisory agencies tend to see some things in a different way, and this can complicate policy. For example, Flinn said that national banks were subject to requirements of the Federal Reserve Act and the FDIC Act, as were all members of the FED and the FDIC. National banks, however, were regulated, <u>only</u> by the Comptroller, e.g., examinations, branches, mergers, and "incidental powers" such as mortgage companies.

In addition to these factors there were minor differences in regulatory policy with regard to capital requirements, loan limits, etc. Furthermore, the Comptroller's ruling allowing national banks to own a mortgage company, which involves the question of banks owning stocks and of possible violation of branching laws was seen by Flinn as a major difference, which was disturbing to many people. In this case a holding company could not operate a mortgage affiliate, but its national bank affiliate could.

<u>Lack of a single corporate image in the marketing context.</u> The identity factor, Flinn explained, works both for and against the holding company. It is an advantage in some local markets where the banking relationships tend to be highly personal and the customer has a banking association of a long-standing nature. On the other hand, the single corporate image of a merged system or a holding company which

uses a standard affiliate identification (i.e., Marine Midland) tends to be an important marketing characteristic in other areas and to other types of customers. For example, the urban customer may be more attracted to a large branch system for the uniformity of services he receives, i.e., his account is good in any branch in the market area while in a holding company each affiliate is a separate bank. This separate identity problem of holding company affiliates, Flinn continued, can be offset to a degree by having wire service verification. In addition, Bankshares and some other holding companies have developed an identifying corporate symbol for use by each affiliate for market identification.

IV. SIGNIFICANT FACTORS IN BANKSHARES' EXPANSION STRATEGY

Flinn discussed four significant factors in Bankshares' expansion strategy. These factors are identified in summary form below.

-- Expansion was directed toward growth areas, with emphasis on the Virginia urban corridor from Washington, D. C. south to Richmond and east through Williamsburg, Newport News, and Norfolk.

-- Acquisition strategy was to acquire a leading bank in an area, if possible a bank with deposits over $10 million.

-- Emphasis was placed on local autonomy and a decentralized management philosophy.

-- Acquisition policy was to deal directly with and through management and not the shareholders of prospective affiliates.

Expansion was directed toward growth areas. Flinn said that a growth area was defined as possessing above average potential in population and industrial expansion. Emphasis was placed on population growth because banking growth comes along with people, and industry tends to move where the labor supply is abundant. He said that the growth area in Virginia for the past 10 years was in the urban corridor, south from Washington to Richmond then east through Williamsburg to Newport News and Norfolk. Nearly 50 percent of the population lived in that belt at the onset of Bankshares' operations in 1963.

Four of the original six affiliates were located in this urban corridor, Flinn explained. Two banks were located in the Washington metropolitan area, one in Richmond, and one in Newport News. The fifth bank was in Lynchburg, a major metropolitan area in Virginia. Lynchburg was seen as a key city. It had good industry and above average growth potential. So, Flinn explained:

> "Bankshares was interested in going into other cities that were not in the corridor in order to become statewide. Yet, we were not interested in picking small country banks, because they do not have growth potential in our opinion, and serve only a very limited area."

The sixth bank among the regional affiliates was in Franklin, a small community south of Richmond. According to Flinn, this bank was an exception to Bankshares' growth strategy.

Speaking further about low growth areas, Flinn observed that one major system in Virginia was merging banks throughout the state in small rural communities.

> "I don't know what they see in these areas. We have heard them say that they can take a bank and operate it so that it is going to earn so much on total assets. We feel we can do the same thing, but we are interested in growth rather than just keeping a small branch that is never going to amount to anything."

Acquisition strategy was to acquire a leading bank in an area, if possible a bank with deposits over $10 million. According to Flinn, the first phase was based on putting together a group of banks in key locations in growth communities. "At the outset we were particularly interested in getting the leading bank in a community--one with a good reputation, good management, and one which was well established. We wanted to create a strong group." Yet, he continued by saying that the strategy was to put together a package which was not too big or too small, i.e., one which would get through the regulatory maze. "We just made it," he emphasized. "Any greater size in our original package would have probably been turned down. The "Fed" just does not react kindly to large holding company formations."

While Bankshares was interested in the largest bank in an area, Flinn said that they knew practically speaking, they could not get the largest bank because the Federal Reserve would not approve such a combination. But he continued:

> "Bankshares did get the largest bank in Northern Virginia (First and Citizens of Alexandria--$61.8 million in deposits), the second largest in Richmond (State-Planters--$220.3 million), and the second largest in Newport News (Citizens and Marine Jefferson--$18.9 million) and Lynchburg (First National Trust and Savings--$33.6 million)."

However, after the initial organization of Bankshares, Flinn said that the size of any subsequent acquisitions became a more important consideration. He explained, "We did not think that we could continue to acquire the dominant bank in other communities because the regulatory authorities were concerned over large bank combinations. The rules were changing, i.e., court cases and agency decisions. Other groups were active, too." He said that Bankshares acquisition of the largest bank in a community would be looked upon as putting the smaller banks at a disadvantage. But if Bankshares proposed to acquire one of the smaller banks the chances for approval would be greatly improved. However, Bankshares generally was not interested in looking at smaller banks, under $10 million in deposits. Flinn said:

> "You have more problems with banks under $10 million and have to spend more

> time working with them. We have a small staff whereas Virginia Commonwealth and First Virginia operate, by and large, with a large holding company staff. A larger staff allows them to acquire more smaller banks."

Flinn added that given a choice (and others would probably feel the same way) Bankshares preferred banks over $25 million, since they can be staffed and equipped to take care of day-to-day operations without detailed supervision. He continued:

> "In such cases these banks run themselves except for some of the sophisticated services that the holding company can give them, i.e., supplying capital, helping in taxes, insurance, accounting, purchasing, investment portfolio, marketing, and computer applications."

Bankshares placed emphasis on local autonomy and a decentralized management philosophy in operation of affiliates. According to Flinn, Bankshares' decentralized management philosophy had been successful in attracting the well managed, profitable bank to affiliate with the holding company. In his opinion the banker operating this type of bank generally was a strong individual who did not want to give up any measure of operating responsibility. Therefore, local autonomy stemming from a cooperative management philosophy was very helpful in attracting additional partners.

Banks interested in joining Bankshares were told that the holding company retained central direction in the following

areas: (1) changes in top management (the top two) and their salaries; (2) dividend policy; (3) matters which could result in a conflict of interest, and (4) purchase of fixed assets or leasing new offices. Affiliates were authorized to spend up to their depreciation for new assets, but anything more required approval by the holding company. In this way, Flinn explained, Bankshares coordinated real estate and purchases of major assets throughout the system, i.e., Bankshares had raised $12.5 million to meet affiliates' plans for expansion.

Bankshares' acquisition strategy has been to deal directly with the bank management. "An acquisition cannot work well," Flinn explained, "without the full cooperation of the management of the bank being acquired. Our philosophy as a holding company has been that the prospective affiliate's management was to run the shop. If you don't have him on your side you might as well forget the acquisition." Because of this factor, he said that Bankshares made no effort to go around management and talk to the big stockholders if it appeared management was reluctant to join.

V. HIGHLIGHTS OF OPERATIONS DURING THE 1962-1966 PERIOD OF EXPANSION BY HOLDING COMPANY

This section of the report contains statistical data on the results of Bankshares' expansion during the 1962-1966

period. Table A-I is a chronological list of acquisitions, and Table A-II is a summary of new marketing areas entered and new services offered during the period of expansion. Table A-III is a summary of operating statistics for the years 1962-1966.

TABLE A-I

LIST OF BANKSHARES' ACQUISITIONS AND AFFILIATE MERGERS

		Acquired Bank Deposit Size (millions)	Banking Offices Added
Jan. 1963	State-Planters of Commerce and Trust, Richmond	$220,308	17
Jan. 1963	First and Citizens National Bank of Alexandria	61,772	8
Jan. 1963	First National Trust and Savings Bank of Lynchburg	33,520	5
Jan. 1963	Citizens Marine Jefferson Bank, Newport News	18,855	3
Jan. 1963	The Vienna Trust Company, Vienna	15,116	4
Jan. 1963	Merchants and Farmers Bank of Franklin	4,903	1
Oct. 1964	Citizens National Bank of Hampton (merged into Citizens Marine Jefferson Bank and name changed to Citizens and Marine Bank)	16,635	7
May 1964	Shirlington Trust Company, Arlington (merged into First and Citizens National Bank)	12,845	3
Aug. 1965	Tri-County Bank, Mechanicsville (merged into State-Planters)	11,508	4
Dec. 1965	Peninsula Bank and Trust Company, Williamsburg	22,313	3
Oct. 1966	Rockbridge Bank and Trust Company, Lexington	9,819	2
Oct. 1966	Spotswood Bank, Harrisonburg	15,933	1
Jan. 1967	Seaboard Citizens National Bank, Norfolk (consolidated with Merchants and Farmers Bank)	110,506	15
	Total Deposits Added	$554,031	
	Total Banking Offices Added		73

TABLE A-II

UNITED VIRGINIA BANKSHARES

EXPANSION RESULTS: NEW MARKETING AREAS AND NEW SERVICES

1. Twenty New Marketing Areas

- Lynchburg	- Virginia Beach
- Alexandria	- Chesapeake
- Newport News	- Suffolk
- Franklin	- Hopewell
- Hampton	- Holland
- Arlington	- Richmond
- Hanover County	- York County
- Lexington	- Fairfax County
- Harrisonburg	- Williamsburg
- Norfolk	- Petersburg

2. Nine New Services
   - Municipal Bond Department
   - Special Women Consultants
   - Public Funds Section
   - Professional Service Program
   - College Tuition Loan Program
   - Computerized Payroll Services
   - One Check Payroll Plan
   - Marketing Department
   - Planning Credit Card Business

TABLE A-III

UNITED VIRGINIA BANKSHARES INCORPORATED AND AFFILIATES

SIX YEAR CONSOLIDATED FINANCIAL SUMMARY (Amounts in thousands, except Per Share data.)

EARNINGS SUMMARY	1966	1965	1964	1963	1962
Interest on loans.	$ 31,750	$ 21,304	$ 16,643	$ 13,476	$ 11,372
Interest and dividends on securities	7,191	5,431	4,487	4,083	3,837
Other income	6,910	4,746	3,978	3,411	3,159
Total Operating Income	45,851	31,481	25,108	20,970	18,368
Interest on time deposits.	13,448	8,642	6,022	4,378	3,590
Salaries and employee benefits	11,937	8,280	6,545	5,859	5,413
Other expenses	9,405	6,399	5,315	4,470	3,842
Total Operating Expenses	34,790	23,321	17,882	14,707	12,845
Net operating earnings before taxes	11,061	8,160	7,226	6,263	5,523
Income taxes and minority interests	3,433	2,715	2,729	2,635	2,269
Consolidated Net Operating Earnings.	7,628	5,445	4,497	3,628	3,254
Net security profits (losses) after taxes.	(1,946)	(367)	22	(143)	(849)
Net loan losses before tax credit	795	355	521	165	73
BALANCE SHEET SUMMARY (Daily Average Figures)					
U. S. Government Securities.	$ 85,514	$ 79,066	$ 73,484	$ 81,281	$ 89,707
Municipals	94,943	67,321	49,784	39,986	33,697
Loans (gross, excluding Federal Funds sold).	497,774	349,388	274,527	233,289	201,241
Reserve for Loan Losses.	8,334	5,100	3,733	2,983	2,863
Deposits:					
Demand	397,241	322,435	285,839	271,419	255,742
Time	338,730	231,970	172,370	136,420	116,304
Total.	735,971	554,405	458,209	407,839	372,046
Stockholders' Equity	58,077	44,672	38,588	36,596	34,900
AVERAGE RATES EARNED AND PAID (Taxable Equivalent Basis)					
U. S. Government Securities.	4.80%	4.35%	4.20%	3.66%	2.97%
Municipal Securities	6.28	5.73	5.77	6.02	5.60
Total Securities	5.57	5.00	4.81	4.41	3.67
Loans.	6.30	6.10	6.06	5.70	5.65
Total Earning Assets	6.10	5.66	5.61	5.20	4.87
Total Time and Savings Deposits.	3.97	3.73	3.49	3.21	3.09
RATIOS					
Net Operating Earnings to Total Operating Income	16.6%	17.3%	17.9%	17.3%	17.7%
Net Operating Earnings to Average Stockholders' Equity . .	13.1	12.2	12.6	9.9	9.3
Net Loan Losses to Daily Average Loans	0.16	0.10	0.19	0.07	0.04
Loans to Deposits, Daily Average Basis	67.6	63.0	59.9	58.0	54.1
Year-end Capital Funds and Valuation Reserves to Daily Average Deposits	9.8	9.9	10.5	10.6	11.2
PER SHARE					
New Operating Earnings	$3.49	$3.18	$2.91	$2.46	$2.21
Dividends	1.52 1/2	1.42 1/2	1.25	1.20	.89
Number of Shares	2,186,434	1,711,869	1,546,910	1,474,610	___
Number of Stockholders	7,448	6,123	5,216	4,702	___

SOURCE: 1967 Annual Report for years 1963-1966; Secretary Treasurer United Virginia Bankshares for year 1962.

APPENDIX B

THE BANK OF VIRGINIA

I. PURPOSE

This material was collected in connection with a study of two banking systems in Virginia which chose different methods of expanding their banking operations on a statewide basis, as a result of the enactment of libralized branching legislation in 1962. The two forms of expansion are direct merger and holding company. This element of the study concerns the development of historical information relating to the issues which led to changes in the branching legislation in Virginia in 1928, 1948 and 1962. Specifically it explores the role of The Bank of Virginia in these developments.

II. HISTORICAL BACKGROUND OF THE BANK OF VIRGINIA

Prior to 1928 the banking legislation in Virginia permitted banks to establish de novo branches in areas throughout the state. However, The Bank of Virginia (then The Morris Plan Bank of Richmond) was the only bank which had expanded into the major population centers apart from its home office in Richmond.

The Morris Plan Bank of Richmond was founded in 1922 by Thomas C. Boushall,[1 & 2] who had been an officer of the

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[1]This report concerning the background on The Bank of

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then National City Bank of New York. Interested in starting a Morris Plan Bank in Richmond, he received a franchise and financial backing from Arthur J. Morris, who was franchising the Morris Plan throughout the country. A Morris Plan Bank was a financial institution which accepted as deposits only savings accounts and which made only instalment loans to individuals. This system of Morris Plan lending was devised by Arthur J. Morris, who is still a director of The Bank of Virginia. In 1910 when Mr. Morris opened the first Morris Plan Bank in Norfolk the availability of credit to average wage earning individuals was almost non-existent. The original approach to the Morris Plan Bank was designed to fill the need for credit facilities for wage earners throughout the United States who were not receiving this service from commercial banks of the day.

The Morris Plan Bank of Richmond opened in 1922. It was established with a regular bank charter. It did not, however, exercise its authority to take demand deposits or

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Virginia is based on interviews with Mr. Thomas C. Boushall, honorary Chairman of the Board and founder of The Bank of Virginia, and Mr. Frederick Deane, Jr., current President of The Bank of Virginia. Paraphrased text and direct quotes are used to summarize the interviews. This report contains no opinion, editorial comment or analysis by the researcher.

[2]The bank has had only two chief executive officers since its founding in 1922. The current chief executive is Mr. Herbert Moseley. He succeeded Mr. Boushall in 1959.

provide other commercial services. Activities were limited to savings accounts and instalment loans to individuals and small businesses. Late in 1922 a branch opened in Petersburg, and in 1925 another branch opened in Newport News, the latter by merger with the Merchants and Mechanics Savings Association. In 1928 a Roanoke branch was opened, and that same year the Morris Plan Bank of Norfolk was merged into the Morris Plan Bank of Richmond as its Norfolk branch. The Morris Plan Bank of Norfolk was the original Morris Plan Bank founded by Arthur J. Morris in 1910 under the name of Fidelity Loan and Trust Company.

The fact that only one bank in Virginia was expanding statewide in the 1920's was commented on by Boushall. This was attributed to the attitudes of bankers at that time and to the geographic divisions of the State. Bankers' attitudes, the first factor, were described as being "steeped in tradition". For example, a typical comment of commercial bankers to the chief executive of The Morris Plan Bank of Richmond concerning branching was that it was poor banking practice and an unnecessary risk to have someone else lend your money, i.e., in the branches in cities distant from Richmond. And further it was said that lending to the consumer was a dangerous practice since they were not a reliable or desirable account and since it was likely that this type of loan would have an unacceptably high default rate. On the branching

issue, Boushall further commented that bankers failed to recognize a branch was not <u>someone else</u>, but was an extension of the main bank. Thus, the branching activities of The Morris Plan Bank of Richmond and their entry into consumer instalment loans went against the grain of the tradition of commercial bankers in Virginia. These deviations, Boushall said, were such an unusual step away from the norm that the Morris Plan Bank of Richmond became an anathema to many bankers in the State.

The second influencing factor discussed by Boushall was that the geographic and economic division of Virginia contributed to the lack of enthusiasm for statewide branching. Virginia was divided into distinct economic and geographic regions, for example: (1) Tidewater Virginia (Norfolk, Newport News, Portsmouth) was maritime oriented, (2) Richmond was tobacco oriented, and (3) Northern Virginia was closely associated with the Federal Government. Further, some areas in Virginia had closer ties (and in some cases still do today) with neighboring states, for example: (1) Bristol, Virginia, in the far southwestern corner of the state, with Tennessee, and (2) the isolated Eastern Shore of Virginia, with Maryland. Therefore, Boushall reasoned that these areas shared few economic, political or social ties and branching across geographic boundaries was unattractive to the commercial bankers.

However, Boushall explained, to The Morris Plan Bank of Richmond branching was considered an essential element of strategy in serving their chosen field--consumer credit. Therefore, branching across intra-state regional areas was attractive so that the bank could serve the consumer who was located in Virginia's major population centers.

In early 1928 the Virginia Bankers Association was preparing to submit to the Virginia General Assembly a revision to the existing banking code. This revision, Boushall explained, was to restrict the authority of banks to branch or merge outside of the home area of the parent bank, and to limit to 4 percent per annum the maximum amount of interest a bank could pay on savings deposits. The Morris Plan Bank of Richmond, a member of the Association, had not been advised of this proposal, which was contrary to many of its basic policies. The bank had been paying 5 percent interest since its founding in 1922 and had made known its desires to open branches in Roanoke and Norfolk, in addition to its existing branches. According to Boushall, the commercial banks saw the 5 percent savings rate as a threat to drain away their savings deposits.

During the 1928 session of the General Assembly the Chairman of the Legislative Committee and the Secretary of the Virginia Bankers Association called on the President of The Morris Plan Bank of Richmond and suggested that if the bank's representatives would support the proposed code change

limiting savings interest to 4 percent, the Legislative Committee of the Association would undertake to have the code amended specifically to permit branches in cities other than that of a bank's head office, provided the cities would have a minimum population of 50,000. This compromise was accepted by the Morris Plan Bank, and it was subsequently incorporated into the 1928 banking code.

Boushall explained that an ironic twist to this power play by the commercial banks was that The Morris Plan Bank of Richmond wanted to reduce their 5 percent savings rate, yet could not for fear of losing depositors. It so happened that the bank was having a difficult time attracting savings even though 5 percent was paid and most Richmond commercial banks paid 3 percent and other areas 4 percent. A large segment of the saving public shared the feeling that "something must be wrong" if the prestigious commercial banks are paying out 3 to 4 percent and this new bank 5 percent. Thus, The Morris Plan Bank of Richmond was looking for a way to solve the "5 percent rate problem" and, at the same time continue to expand in the more populated areas of the State. Therefore, the compromise of rate reduction for limited branching proposed by the Virginia Bankers Association was readily accepted.

Between 1929-1948 competition started to develop between the other large banks in Richmond and elsewhere in the state and The Morris Plan Bank of Virginia. During this period the

commercial banks began to expand into the area of consumer finance and, in turn, The Morris Plan Bank of Virginia into commercial accounts. This competition was to become a significant factor in subsequent banking legislation.

During the 1920's and 1930's the maverick Morris Plan Bank of Virginia was not considered a competitor by the more orthodox commercial banks because the commercial banks at that time made very few personal loans. Generally speaking, Deane said that in the eyes of commercial bankers The Morris Plan Bank was considered nothing more than a high-class small loan company. This attitude, he continued, was aggravated by the fact that in the twenties and early thirties banks did not consider it ethical to advertise for loans and the Morris Plan banks engaged in extensive advertising. Deane explained, "Morris Plan banks were characterized as sort of razzle-dazzle promoters from the beginning, i.e., they gave away merchandise to get accounts, etc. While these practices are acceptable today the Morris Plan Banks were doing this at a time when it was considered most improper." Deane reasoned that this practice re-inforced the view of the commercial bankers in Virginia that the small Morris Plan Bank of Richmond was not really a bank at all, and certainly not in the same league with them. As an aside, Boushall noted that there was no other Morris Plan Bank in Virginia after the conversion of the Morris Plan Bank of Portsmouth into the Commercial Exchange Bank around 1940.

As the economic climate changed in the depression so did the policies of commercial banks in Virginia. Boushall said that commercial banks were not making many loans because the national economy was stagnant and commercial customers were reluctant to borrow. The depression also affected consumer lending, but not quite to the same extent, i.e., there was relatively more demand for consumer credit than commercial credit. Boushall recalled that consumer credit began to look profitable to the commercial banks in Virginia since they started to move into this area in the early 1930's.

Before this time commercial banks had shown a general lack of interest in the consumer business. For example, the American Bank and Trust Company of Richmond opened a consumer loan department in 1927. This action had a startling impact on the banking community in Virginia and elsewhere.[3] Yet, Boushall said, two factors illustrated a continuing lack of interest in consumer instalment loans by the American Bank and Trust Company. First, after establishing the consumer loan department it was located in the basement of its building. And second, in 1933, when the bank did not reopen after the bank holiday,"paper" from its consumer loan department

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[3]In addition, Boushall stated that the National City Bank of New York (now the First National City Bank) came to The Morris Plan Bank of Virginia to obtain the procedures and forms for establishment of their consumer instalment loan operations in 1928.

was offered to The Morris Plan Bank of Virginia--the total of this paper was approximately $116,000 after almost five years of consumer credit business. This amount was negligible when compared to The Morris Plan Bank of Virginia's $7-1/2 million. To further illustrate the general lack of interest in consumer credit by commercial banks, Boushall recalled that The Morris Plan Bank of Virginia, in 1937, held more consumer instalment loans than all of Virginia's commercial banks and finance companies combined. And yet another example was an effort on the part of a New York correspondent bank to drop the Morris Plan Bank of Virginia's $300,000 line of credit unless the dangerous practice of auto loans and its planned new office construction were stopped.[4]

As commercial banks moved into consumer credit in the 1930's, policy changes were initiated at The Morris Plan Bank of Virginia to broaden the scope of services by expanding into demand deposits and checking accounts.[5] First, only checking accounts of individuals were taken, then commercial checking accounts. And just before World War II The Bank of Virginia

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[4]In 1928 The Morris Plan Bank of Virginia was the first bank in the state to buy dealer automobile paper, and in 1935 the first to do extensive direct (over-the-counter) collateral auto loans to consumers.

[5]Boushall noted that government insured FHA Home Improvement Loans in 1934 were a factor which brought Virginia's commercial banks into the consumer area.

entered into the commercial lending field in active competition with the other commercial banks. However, the war intervened and not much progress was made. Thus, the active commercial growth and development phase of The Morris Plan Bank of Virginia did not start until 1945. On January 1, 1946 the bank name was changed from The Morris Plan Bank of Virginia to The Bank of Virginia in order to qualify more specifically for this commercial accounts business.

By 1948 Boushall said that The Bank of Virginia was successfully implementing its strategy of expanding into the commercial area in direct competition with the commercial banks. It was the only bank in the state which had developed a branch system in cities with a population over 50,000, and it had plans to expand into new areas when these areas met the population provisions of the branching laws. For example, it was expected that Alexandria would meet the 50,000 population requirement after the 1950 Census, and negotiations with a bank in Alexandria were initiated. This alerted other banks to the continuing expansion plans of The Bank of Virginig.

To this point in time Deane said that The Bank of Virginia had grown up "relatively unnoticed" by the other commercial banks, i.e., because they had not felt that it was a legitimate competitor, and because it was not until after World War II that The Morris Plan Bank of Virginia became an

active, aggressive competitor of commercial banks in the commercial accounts area. However, by 1947 the bank had grown from among the smallest in Virginia in 1922 to become the sixth largest in 1947. Therefore, the expansion activities of The Bank of Virginia were seen as a competitive threat to other banks in Virginia who still were not interested in branching. As a result of this situation the Virginia Bankers Association, for the second time in 20 years, sponsored a change to restrict branching, which the press[6] reported was aimed specifically at The Bank of Virginia. Restrictive branching legislation was passed in 1948 after a bitter fight in the General Assembly.

There was another factor in the 1948 controversy which Boushall said was a matter of concern to those who viewed the activities of The Bank of Virginia with alarm. This was the question of out-of-state control. Since its founding The Bank of Virginia had been controlled by the holding company established to franchise Morris Plan Banks throughout the United States. As late as 1953, when the control of The Bank of Virginia was sold, the holding company still owned 57 percent. This factor tended to increase the unfriendly feeling of the other commercial banks in Virginia towards The Bank of

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[6] Boushall noted that editorial coverage in the press favored the position of The Bank of Virginia by a margin of 22 to 0.

Virginia. It was used by the opponents of The Bank of Virginia in the hearings on the 1948 legislation to illustrate one of the "alleged dangers" of branching.

Over the period 1949-1962 several factors caused the bankers in Virginia to re-evaluate the legislation restricting expansion of the banking system. These factors were: (1) competition from holding companies which were not regulated under state law, and which were expanding throughout Virginia, (2) competition from out-of-state banks which had larger credit lines to serve the growing needs of industry in Virginia, and (3) the requirement to provide banking services in the fast growing urban sections of the state. Spurred by these pressures seven banks joined together in early 1961 to lift the ban on branching. They formulated "The Richmond Plan" (later known as "The Virginia Metropolitan Plan") which proposed branching in metropolitan areas throughout the state. Boushall recalled that these banks were: (1) First and Merchants National Bank of Richmond, (2) State-Planters Bank of Commerce and Trust of Richmond, (3) Central National Bank of Richmond, (4) National Bank of Commerce of Norfolk, (5) First National Exchange Bank of Roanoke, (6) Peoples National Bank of Charlottesville, (7) Shenandoah Valley National Bank. The Bank of Virginia was not included since it had been the focus of the then existing bank restrictions.

Prior to the convention of the Virginia Bankers Association in June, 1961, sponsors of this plan visited bankers throughout the state to generate support for legislative changes. Their objective was to gain endorsement of the plan at the convention for subsequent presentation to the General Assembly in January 1962. But opposition to the plan was strong, and during the Virginia Bankers Association convention, in June 1962, the matter was referred for study to a special committee (The Kramer Committee). Boushall explained that it was originally proposed that the Kramer Committee report to a special convention of the Virginia Bankers Association in November 1961 so that the Virginia Bankers Association could bring the issue before the 1962 General Assembly. But this special convention provision was voted down under a motion by Mr. Harry Nichols, President of the Southern Bank of Norfolk. Therefore, any Virginia Bankers Association sponsored action to ease expansion restriction was delayed two and one half years to January 1964, when the Virginia General Assembly would again meet.[7 & 8] Thus, the opponents to more liberal

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[7]This situation, Boushall said, resulted in The Bank of Virginia's action to form a holding company as a means of avoiding the expansion restrictions rather than wait another three years for possible resolution of the branching issue.

[8]The Virginia General Assembly meets every two years.

expansion provisions were successful in putting off final resolution of the issue.

At the beginning of the 1962 General Assembly, while the Kramer Committee was still formulating a position on branch banking, the Buck-Holland Bill, which favored statewide branching was introduced. Boushall said that the bill was a complete surprise to the Virginia banking community. It came about as the result of independent action of two legislators, Senator Fred C. Buck and Delegate Shirley T. Holland. They were presidents of relatively small banks in Virginia. Both Buck and Holland acted on their own, independent of the study being made by the Virginia Bankers Association. In particular, Boushall said that Mr. Holland's motivation was based on the recognition of long run needs of the State of Virginia, and also to give banks a choice between merger and joining a holding company group.

The Buck-Holland Bill, which became effective on July 1, 1962 opened a new era of banking in Virginia. The bankers in Virginia interested in statewide expansion now had three methods to achieve their objective:

1. Expansion by merger.
2. Expansion by holding company.
3. Expansion by both holding company and merger.

APPENDIX C

FIRST AND MERCHANTS NATIONAL BANK

I. PURPOSE

This material was collected in connection with a study of two banking systems in Virginia which chose different methods of expanding their banking operations on a statewide basis, as a result of the enactment of liberalized branching legislation in 1962. It is based on interviews with Mr. John Green, Vice President and Mr. C. Coleman McGehee, Executive Vice President of First and Merchants National Bank. The information is presented in the form of paraphrased text and direct quotes. It contains no opinion, editorial comment, or analysis by the researcher.

This part of the study concerns the experiences of First and Merchants National Bank of Richmond (hereafter called First and Merchants) which chose to expand by direct merger. The focus of this information is on: (1) the central issues in management's selection of the most appropriate form of expansion, i.e., the significant characteristics considered by First and Merchants to be advantages of expansion by holding company, and (2) significant factors in First and Merchants' expansion strategy.

Case prepared, 1968, by Paul L. Foster, doctoral candidate.

II. BACKGROUND

The passage by the Virginia General Assembly of the Buck-Holland Bill in 1962 gave First and Merchants and other Virginia banks significantly greater opportunities for expansion. After the 1962 legislation, statewide expansion could be undertaken by: (1) holding company affiliation, (2) merger, or (3) a combination of the two. Before that time, holding company affiliation was the only alternative available for expanding banking operations beyond the general locality of the home office.

Prior to 1962, First and Merchants had contemplated expansion under the Virginia Metropolitan Plan, a plan to allow merger between banks in metropolitan areas. However, the plan did not gain sufficient support of Virginia bankers to be proposed as an amendment to the state banking codes in the 1962 General Assembly. One reason for the failure of Virginia bankers to support the Virginia Metropolitan Plan was advanced by Green, a member of a group appointed to generate support for the plan throughout the state. He indicated that the plan was sponsored primarily by the larger banks in Richmond. But to be accepted as a resolution by the Virginia Bankers Association it needed support of the large number of small banks in the state. This support was hard to gain because of dangers which the small banks felt to be inherent in

statewide branching systems. The small bankers were reluctant to give up marketing area protection enjoyed under the 1948 legislation, regardless of the broader economic benefits to the state.

First and Merchants, at that point, considered the holding company route, but the surprise passage of the Buck-Holland Bill gave First and Merchants an opportunity to reconsider its expansion plans. As explained by an officer of First and Merchants:

> "We were actively studying the formation of a holding company and had retained the services of experts in the field. Our planning for a holding company had moved right along, but we feel fortunate, from our standpoint, that the Buck-Holland legislation got into the mill in time for us to take advantage of it. That is to say, we had not gone so far that we could not scrap our plans for a holding company, and embark on a program for expansion by merger, as authorized under the 1962 legislation.
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> On this same subject, we believe (we do not know) that if some of the others had not gone so far with their commitments for the holding company form, they would have changed their plans also. But, we feel some had gone so far that they just could not back up and they had to go ahead with their commitments."

III. IDENTIFICATION AND DISCUSSION OF THE FACTORS CONSIDERED BY FIRST AND MERCHANTS IN THEIR DECISION TO EXPAND BY MERGER

Advantages of Expansion by Merger

Nine significant factors considered by First and Merchants' management to be advantages of expansion by merger, as contrasted to or different from expansion by holding company, were cited by Green. These factors are listed below:

-- The merged form of banking organization provides a basis for better organizational control than does the holding company form.

-- Expansion by merger provides a better solution to the problem of management succession.

-- Merger provides for greater mobility of funds.

-- Merger provides for greater diversification of risk.

-- Merger provides for increased lines of credit to a single customer.

-- Merger provides for greater financial flexibility.

-- Merger creates larger individual banking units which are better able to attract industry to Virginia's growing industrial communities.

-- Merger provides for greater community services.

-- Merger provides for economies in operation.

The merged form of banking organization provides a basis for better organizational control than does the holding company form. Green stated that the merged organizational

form has only one policy group, its board of directors, and one group of senior management to execute policy. Therefore, it is more likely that potential problems in policy development and execution can be avoided, and coordination to achieve "unity of purpose" can be more readily attained than in an organization with more than one policy group. In addition, one group of senior management to carry out the policies of a single board tends to reduce the time and effort required of management at the local level on policy matters--this, then, gives the local management more time to devote to business development and service to the customer.

Green contrasted the single board of directors of the merged organization to the holding company, in which each bank, being a separate corporate entity, has its own board. It was his comment that when the policies of the boards of each holding company affiliate vary according to the individual desires or thoughts of these individual groups of management, then the unity necessary to operate effectively a large banking organization is hard to achieve.

<u>Expansion by merger provides a better solution to the problem of management succession</u>. "Management succession is one of the critical issues facing the banking industry today," Green stressed, "particularly as the problem concerns smaller banks." He cited three general reasons why expansion by merger

provides a better solution to this problem than does expansion by the holding company method: (1) the merged form requires relatively fewer management personnel at the policy development and operating levels, (2) larger individual banking institutions are in a better position to attract and hold young management talent, and (3) flexibility in movement of management personnel in merged organizations is greater.

Green stated that the management succession problem that confronts each institution today, particularly smaller and medium size banks, cannot be over emphasized. Under the holding company affiliation, in which separate corporate identity is maintained, the need of management at all levels still exists. Each separate bank will continue to experience difficulty attracting and holding personnel. This problem is less serious in a merged system since only one organization is involved. Thus, he said that there tends to be more efficient allocation of banking's scarest resource--management personnel.

According to Green, the larger the single institution the greater the attractiveness to the younger person. He illustrated this in several ways. For example, he noted the sentiments of the Chief Officer of a bank in a remote, outlying area on the problem of recruiting and training programs. Green recalled this officer said:

> "How can I conceivably attract anybody to come here and live? As far as profits of the bank are concerned and

> because of lack of loan demand it is difficult to pay a beginning salary to attract good young management. And, furthermore, what is really available here in the community to attract permanent management? There is nothing here, except what has existed back through the century. Young qualified and educated people are interested in going where they can grow and where they do not have a definite ceiling placed on their abilities. They do not want to come here."

Green continued by saying that the same problem applies to many locations in Virginia. However, when a location such as that described is part of a large organization like First and Merchants, a young man would be more willing to take an assignment as branch manager since he knows that top management is evaluating him, and that this is a training ground or stepping-stone to bigger things. It is not a lifetime job.

According to Green the merged form has an advantage over the holding company in terms of flexibility in movement of management personnel. He explained that in a holding company each individual bank is responsible for maintaining and managing it's own personnel, and management transfers can result in a situation where a conflict of interests arises between two corporate identities and two boards of directors. In a merged system there is less of a tendency for conflicts to arise because the man is a member of one organization in the eyes of the personnel committee, the President, the Chairman of the Board, and the senior executive staff. He

can more easily be moved within the organization. It was Green's opinion that the holding company as the prime organization, cannot achieve this flexibility in movement of management.

Merger provides for greater mobility of funds. Illustrating this point, Green said that funds required in one area can be supplied from another, thereby circumventing the need of participation among several organizations, as in a holding company. In this particular connection (and this point was emphasized) it is possible for a branch in a high loan area to have 100 percent or better of its deposits invested in loans--this could not be done in an independent unit bank or holding company affiliate.

Green noted that a holding company competitor in the same area, through participation, could (in theory) place the same amount of loans. "But," he stated, "this does not work too well in practice since participation must go through the separate boards of directors of a holding company, and each may not react the same way. The extension of credit is personal judgment--it is not an exact science by any manner of means." Further he said, "While the holding company could say what will be done in a certain situation, the board of directors of an affiliate is still required by law to exercise independent judgment, or be subject to legal action."

Merger provides for greater diversification of risk. According to Green, the pooling of funds in a merged system provides for greater diversification in the loan portfolio and investment account.

Merger provides for increased lines of credit to a single customer. Green illustrated this point by the fact that First and Merchants, in 1962, could lend one customer approximately $1-1/2 million, because the ability to lend to one borrower was restricted by capital structure. And in order to lend $5 million in 1962 it required nine banks to participate. Today, First and Merchants, alone, can manage $3-1/2 million to one borrower; and just a few large Virginia banks are needed to lend $5 million.

In the absence of the merger law, the only way capital structure could have been increased would have been by retained earnings or the sale of additional stock. It was Green's strong opinion that First and Merchants' capital funds would have been much less had not mergers taken place. He also stated that First and Merchants is still not the size desired, either in capital or deposits.

Merger provides for greater financial flexibility. Green noted that a group of independent banks are separate entities--independent organizations versus one. When capital is needed it is generally needed in aggregate. He reasoned that if there

is one capital account, it is much more easily controlled and manipulated than if the account were in many independent units. So, for that reason, merger is definitely an advantage, argued Green.

"A merged organization is not restricted to selling equity," Green said. "It can sell debt instruments or preferred stock." In fact, he thought that a merged organization probably would have a little more of an advantage when selling equity because, in the case of First and Merchants, it would be known all over the state of Virginia, and has been known all over the state of Virginia, for one reason or another, for 102 years. He said:

> "To buy First and Merchants National Bank stock there is acceptability of the equity and debt instruments at the local community and this would be much greater than it would be for a holding company that does not identify to any bank. Today there is a problem, so the bankers say, in the identification of a holding company with a bank in the community, i.e., people in the community tend to get mixed up. However, this does not apply to a sophisticated investor, but to the man on the street, it does."

Therefore, he reasoned a merged organization might have a little advantage over a holding company in the sale of equity or the sale of debt instruments to raise capital. For example, in floating an issue much would depend upon the area in which this equity or debt structure was to be held. If it were to be held in Richmond probably the name First and Merchants

would be more readily accepted than the name United Virginia Bankshares, a holding company. However, that would not be true for the name of First and Merchants versus the State-Planters, the lead bank in the holding company. But the name of State-Planters does not appear since its stock is owned by United Virginia Bankshares.

In addition, Green observed that it is the peculiarity of local citizens to want to own bank stock. But, they want to own, in particular, local bank stock, instead of many of the local industrial corporations. Therefore, he reasoned that <u>a local bank name</u> is a more valuable asset in this environment than a holding company name.

<u>Merger creates larger individual banking units which are better able to attract industry to Virginia's growing industrial communities</u>. "Industry is more naturally drawn to the larger financial organizations which can better serve some of their needs," stated Green. Although he said that holding company advocates would say the same is applicable to their group, the argument is much more difficult to see and the details much more involved to handle. He believed, "There is a natural attraction for large industry to go with the larger financial organizations, because they know from experience that they can be better served." The attractions of the larger banking organizations to industry are: (1) larger credit lines, and (2) the wider range of services which is generally available.

<u>Merger provides for greater community services</u>.

> "A large merged organization brings to the local community specialization in many fields, including specialized banking services and loans plus a wide variety of trust services, not otherwise available. In other words, it makes available at the local level the full facilities of the larger institution, as each branch office can perform any and all services <u>just as though it were the main office</u>. This is something that definitely can not be done to the same degree in a holding company organization."

In addition, Green stated, "Direct contact with the specialist in the bank of your choice, as in a merged organization, appears to give the customer more confidence than in the holding company where the specialized services may be performed by a bank of another name, or the holding company."

<u>Merger provides for economies in operations.</u> Green cited several arguments in favor of merger which lead to operating economies, such as: (1) concentrating purchasing power for supplies and other items, (2) grouping the insurance coverage, (3) more efficient use of automatic data processing equipment, and (4) improved administration of personnel policies. However, he noted that these savings can be offset by the cost associated with new services, improved quality of existing services and other factors. For example, Green explained that the size of the merging bank, measured by total deposits, is a consideration in mergers. A smaller bank usually can be integrated into the system with greater ease, i.e., merger

with a larger bank tends to involve problems involving functions and personnel in the merged bank normally centralized in the home office. For example, in talking about the problems of duplicate or excess personnel after a merger, Green said:

> "Let me say that the hoped for economies have not been as realistic as we had thought they would be, and we have not experienced them yet. We hope to in the future, but I think we would make a very serious mistake if we tried to achieve economies through a negative approach. I consider reducing the merged staff by arbitrary laying-off or just saying you do not have a job because we eliminated your position to be a terrible mistake to make at the local scene.
>
> In no case have we dispensed with personnel services as a result of merger. Normal attrition has taken care of this problem. That has been a policy long before to the passage of the merger law."

Disadvantages of Expansion by Merger

Only three main arguments favoring the holding company form of expansion were considered significant factors by First and Merchants in weighing its alternatives to expand by merger or by holding company. These factors are listed below.

-- Loss of the merged bank's name is a disadvantage of expansion by merger.

-- The change in status of the merged bank's board of directors is a disadvantage of expansion by merger.

-- Restrictions against <u>de novo</u> branching in the area of the merged bank are a disadvantage of expansion by merger.

<u>Loss of the merged bank's name is a disadvantage of expansion by merger</u>. According to Green, "It is surprising how important an existing bank's name can be to the bank's management. In many instances bank management does not want the name to disappear, and under the holding company route the name can be continued." The counter argument against retention of the local bank's name, he said is that the First and Merchants National Bank (which is over 100 years old) has served the state of Virginia many, many years, and in most cases far more years than the local banks.

In further discussions, C. Coleman McGehee, Executive Vice-President, pointed out an additional counter argument, which he felt more than offsets the identity advantage alleged to accrue to a holding company. In exchanging the stock of the local bank for the stock of the holding company, the local stockholder in the affiliated bank's area is given the stock of the holding company which may be, as an example, United Virginia Bankshares. Thus, the name of the stock of the local bank which has been picked up as a part of the holding company system is replaced in the eyes of the stockholder. If this same bank had been merged into First and Merchants, the

local stockholders would then have First and Merchants stock, and the name of the local bank would be First and Merchants. Consequently, the local stockholder identifies with a local bank as opposed to a holding company which may be located in some other area. McGehee said that he feels the local association caused by the tie of the stockholders to a local bank is stronger and provides just as much motivation and local identity to stockholders of a merged system as does the retention of the name for a bank which joins a holding company.

In addition, McGehee said a survey of the Tidewater area was made after two years of operation of a merged bank to find out if the depositors knew that they were dealing with First and Merchants as opposed to the local bank. According to McGehee, this survey showed 80 percent of the old depositors who had been doing business with the unit bank associated with First and Merchants. Therefore, he felt this showed excellent acceptance of the merging bank's image in the local community.

The change in status of the merged bank's board of directors is a disadvantage of merger. Another argument in favor of the holding company, cited by Green, is continuation of the local board of directors as contrasted to the need in mergers to substitute an advisory board. In First and Merchants there is only one board of directors. An area advisory board has been substituted in merged banks, using the same

group of men. Green stated that experience with advisory boards has been especially good because the directors are used as they were previously, i.e., for their advice and knowledge of the community and its affairs. The only significant difference noted by Green was that area advisory board members do not have any real legal liability.

Restrictions against de novo branching in the area of the merged bank are a disadvantage of expansion by merger. Probably the most valid argument under the existing law in favor of the holding company, according to Green, is the ability of the local affiliated bank to continue to branch as compared to the frozen situation after merger takes place. For example, he cited Lynchburg as a situation where First and Merchants has five branches, but cannot have any more--yet Lynchburg is growing. On the other hand, a holding company affiliate in Lynchburg can branch wherever it can justify the need.

In the future he hoped--and, of course, there is no way of forecasting future events--that this difference will be eliminated. He said that legislation is needed that will enable merged systems to branch, not de novo statewide (although that may come), but at least to the same extent that a holding company member can now branch.

IV. IDENTIFICATION AND DISCUSSION OF THE KEY FACTORS IN FIRST AND MERCHANTS' MERGER STRATEGY

McGehee and Green discussed five significant factors in the merger strategy of First and Merchants. These factors are listed below and are subsequently discussed as they were related to the researcher.

-- First and Merchants' expansion plan was to merge only into areas where the growth rate of the area will keep pace or exceed the growth rate of the system as a whole.

-- An objective in merger was to avoid dilution of book value and earnings but give "fair value".

-- Strategy was flexible because future mergers may be difficult due to increasing competition for the remaining banks available for merger and due to the attitude of the regulatory agencies.

-- To offset *de novo* branching restrictions in the merged area, merger partners with branch offices are preferred.

-- To offset the loss of the merged bank's board of directors an Area Advisory Board is established.

First and Merchants' expansion plan was to merge only into areas where the growth rate of the area will keep pace

<u>or exceed the growth rate of the system as a whole</u>. As related by Green this was to be accomplished by expansion through merger, primarily in urban and industrial areas throughout Virginia which have above average growth potential. He said that planned expansion was based upon knowledge of these areas throughout the state. For example, it was known that the Northern Virginia, Virginia Beach-Norfolk, and the Newport News-Hampton areas were among the fastest growing sections of the state. In addition, areas such as Alexandria, Winchester, Harrisonburg, Arlington, Fairfax, Staunton, Waynesboro, Roanoke, Bristol, Lynchburg, Martinsville, Danville, were initially considered for expansion since it was felt that the industrial growth potential in these areas was more assured than it would have been in Williamsburg, for instance, (although tourism there was almost an industry in itself), or in smaller rural communities. First and Merchants, Green noted, has not been successful in getting into the Washington metropolitan area, other than in Leesburg which is removed from the immediate pattern, and a facility operation in the Fairfax-Arlington area, which is confined to the Pentagon.

Merger partners were looked at from the standpoint of what could be foreseen as future development in their areas. Based on this factor, Green said:

> "More opportunities to merge were turned down than have actually merged--about three to one. With some of the people that we have known for many, many years, the hardest decision to make was to say no, if according to our analysis, the areas that they represented did not have the required growth potential. Banks like these generally wanted: (1) to share in the future growth and earnings of the First and Merchants system, (2) to solve a management succession problem, or (3) to obtain more marketability for stockholders shares from the merger."

Green explained that growth was an important factor because if the growth rate of a particular area did not keep pace with the rest of the system, then the future earnings of First and Merchants' own stockholders would be diluted, even if fair value was given for fair value. Therefore, he continued, "If the growth potential of a given community was not going to be as good or better than the rest of the First and Merchants' system there was no basis for merger." It has followed that this has kept First and Merchants out of the rural communities, i.e., the real rural communities where the dominant foundation was agriculture. As a consequence, Green described First and Merchants' merger strategy as having very high degree of selectivity. He said, "Others have gone about merger in a different fashion. First and Merchants used a rifle to shoot at the map of the state and others used a shotgun." According to Green, "First and Merchants believes that this strategy is sound, however, there are others who

still contend it is foolish to turn down a merger because the State of Virginia is going to grow, and if you can merge, merge."

An objective in merger was to avoid dilution of book value and earnings but give "fair value". First and Merchants wanted to avoid an immediate effect on stockholders of diluting the book value in a merger. But, Green said:

> "Immediate dilution was not as important as the greater effect on the earnings in the future. For example, if the merged area did not grow as much as the system area in future years then even an exchange of fair values would produce an earnings drag on the system and a premium would have a greater effect."

Strategy was flexible because future mergers may be more difficult due to increasing competition for the remaining banks available for merger and due to the attitude of regulatory agencies. In five years seven mergers have been consumated--Newport News, Lynchburg, Staunton, Waynesboro, Leesburg, Virginia Beach, and Chesapeake. The last merger was in June, 1966. According to Green, the pace of mergers was slow. Recent decisions of the Justice Department, primarily the action not to grant the formation of Allied Bankshares, resulted in the feeling that any combination of consequence in Virginia is not going to be approved. Therefore, Green believed that it will be more difficult to accomplish in Virginia what

has been accomplished in North Carolina in terms of building large statewide systems. The Justice Department attack has been on bigness and potential bigness. The Federal Reserve Board and the Justice Department have been concerned with what they called a tendency toward monopoly.

Green reasoned that the current attitude of the Justice Department may have an impact on the future strategy for mergers. First and Merchants may not be able to be as discriminating as in the past, yet on the other hand, it may be required to be even more discriminating. It was his opinion that if the policy of a high degree of selectivity is continued there will be a slow down in mergers because of the present stand of the regulatory authorities. However, if selectivity is not continued then First and Merchants will have to change policy to coincide with that of some of the other expanding systems who have gone at the merger question with less regard to future growth potential. In any event, Green explained that opportunities would continue to exist for mergers because the regulatory agencies concern for size will not exclude the many small banks in the state who want to (and many times need to) join a system.

<u>To offset de novo branching restrictions in the merged area, merger partners with branch offices are preferred.</u> McGehee pointed out that the <u>de novo</u> branching disadvantage

of merged systems was a fault of the 1962 legislation. Once a bank is merged in a community additional branches can not be established. The only branches authorized are the branches which existed at the time of the merger. On the other hand, a holding company affiliated bank can continue to establish branches in its own community. First and Merchants has tried to offset this disadvantage by merging with banks that have extensive branches.

To offset the loss of the merged bank's board of directors an Area Advisory Board is established. Green, in mentioning the value of a board of directors to a banking community, stated that First and Merchants' policy was to retain the valuable services of board members as an advisory board, "These members have continued to serve with essentially the same enthusiam and effectiveness as before." As stated in the 1963 Annual Report:

> "Advisory boards play an important role in the management and operation of the system, and their particular knowledge of local conditions, their experience in the business life of their own communities, and their often-demonstrated interest in the program of the bank are of inestimable value."

V. HIGHLIGHTS OF FIRST AND MERCHANTS' OPERATIONS DURING THE 1962-1966 PERIOD OF EXPANSION BY MERGER

This section of the report contains statistical data on the results of First and Merchants expansion during the 1962-1966 period. Table C-I is a chronological list of mergers, and Table C-II is a summary of new marketing areas entered and new services offered during the period of expansion. Table C-III is a summary of operating statistics for the years 1962-1966.

TABLE C-I

FIRST AND MERCHANTS NATIONAL BANK

LIST OF MERGERS

Date	Bank	Merged Bank Deposit Size (million)	Banking Offices Added
	Mergers During the Period of Restrictive Branching Legislation		
Jan. 1959	Savings and Trust Company of Richmond	$ 9.9	1
Dec. 1959	First National Bank of Ashland	6.3	2*
Dec. 1961	Petersburg Savings and American Trust Company	20.2	7
		$ 36.4	10
	Mergers During the Period of Liberalized Branching Legislation		
Sept.1962	Augusta National Bank of Staunton	$ 11.1	2
Oct. 1962	First National Bank of Newport News	44.8	6
Jan. 1963	Peoples National Bank and Trust Company of Lynchburg	32.7	6
July 1964	First National of Waynesboro	11.0	2*
Sept.1965	Loudoun National Bank of Leesburg	9.7	3
Jan. 1966	Bank of Virginia Beach	23.9	10*
June 1966	Bank of Chesapeake	12.6	4*
		$145.8	33
	Total Deposits Added by Merger	$182.2	
	Total Banking Offices Added by Merger		43

* Trust Service Added in this area.

SOURCE OF DATA: 1962 Annual Reports.
Century of Service, A History of First and Merchants National Bank.

TABLE C-II

FIRST AND MERCHANTS NATIONAL BANK

EXPANSION RESULTS: NEW MARKETING AREAS AND NEW SERVICES

1. Twelve New Marketing Areas

- Staunton	- Big Island	- Norfolk
- Newport News	- Waynesboro	- Chesapeake
- Fort Eustis	- Leesburg	- Portsmouth
- Lynchburg	- Virginia Beach	- Bedford

2. Seven New Services

   - 1962 & 1963 Data Processing for customer services, accounting and other operations
   - 1963 New Car Dealer Division
   - 1963 Real Estate Division
   - 1963 Marketing Division for banking services
   - 1964 Revised and broadened the bank employee benefit plans
   - 1966 Specialized and professional service to business for pension or profit sharing plans
   - 1966 Planning implementation of national credit card service.

   Studying acquisition of a mortgage affiliate.

TABLE C-III

TEN YEAR RECORD FIRST AND MERCHANTS NATIONAL BANK

DOLLAR AMOUNTS IN THOUSANDS	1966	1965	1964	1963	1962
(Average Figures)					
Demand Deposits	$290,252	$276,047	$259,485	$246,716	$197,514
Time Deposits	210,753	177,939	146,027	127,134	80,737
Total Deposits*	501,005	453,986	405,512	373,850	278,251
Loans (Excluding Federal Funds Sold)	315,077	272,924	235,777	209,538	141,414
Securities	132,631	125,090	122,112	121,625	98,952
Capital Funds	43,485	39,822	37,966	35,790	26,858
Reserves	8,134	7,548	6,576	5,860	4,799
Operating Revenue	$ 30,024	$ 25,037	$ 21,905	$ 19,097	$ 13,468
Operating Expenses	21,606	17,983	15,235	13,301	8,644
Net Operating Earnings Before Taxes	8,418	7,054	6,670	5,796	4,824
Income Taxes Applicable to Operations	2,946	2,586	2,709	2,433	2,095
Net Operating Earnings	5,472	4,468	3,961	3,363	2,729
Dividends Paid--Cash	2,423	1,978	1,850	1,824	1,319
PER SHARE DATA (ADJUSTED):					
Average Shares Outstanding	1,512,725	1,383,053	1,352,519	1,326,101	1,004,328
Book Value--Year End	$ 28.82	$ 28.91	$ 28.11	$ 27.26	$ 26.14
Net Operating Earnings Before Taxes	5.56	5.10	4.93	4.37	4.80
Income Taxes Applicable to Operations	1.94	1.87	2.00	1.83	2.08
Net Operating Earnings	3.62	3.23	2.93	2.54	2.72
Dividends	1.60	1.42 1/2	1.36	1.36	1.27
OTHER SIGNIFICANT STATISTICS					
Loans as % of Deposits (Daily Average Basis)	62.9	60.2	58.1	56.0	50.8
Time Deposits as % of Total Deposits (Daily Average Basis)	42.1	39.2	36.0	34.0	29.0
Gross Earnings Rate on Loans	6.31	5.80	5.78	5.70	5.48
Gross Earnings Rate on Securities (Fully Taxable Basis)	5.40	4.79	4.46	4.05	3.79
Net Operating Earnings (Pre-Tax) as % of Gross Income	28.0	28.2	30.4	30.4	35.8
Net Operating Earnings (After-Tax) as % of Gross Income	18.2	17.8	18.1	17.6	20.3
Net Operating Earnings as % of Average Capital Funds	12.6	11.2	10.4	9.4	10.2
Net Operating Earnings as % of Average Deposits	1.1	1.0	1.0	.9	1.0
Profit (Loss) on Sale of Securities--After Taxes	($1,394,274)	$ 35,617	($334,496)	$32,438	$538,872
Number of Offices at Year-End	56	42	39	37	28

* Deposits acquired at the time of various mergers were in 1959, $16,296,125; in 1961, $20,204,679; in 1962, $55,058,083; in 1963, $32,758,035; in 1964, $11,022,885; in 1965, $9,726,729; in 1966, $35,300,525.

SOURCE: 1966 Annual Report

APPENDIX D

BRANCHING PROVISIONS OF THE 1928 LEGISLATION
(EXCERPTS FROM THE CODE OF VIRGINIA 1942, CHAPTER 164A)

4149 (14) When branch banks may be authorized; branches already established; how operated; penalties. --No bank or trust company heretofore or hereafter incorporated under the laws of this State shall be authorized to engage in business in more than one place, except that, (a) in its discretion the State Corporation Commission may authorize banks having paid-up and unimpaired capital and surplus of fifty thousand dollars or over to establish branches within the limits of the city, town, or village in which the parent bank is located.

(b) The State Corporation Commission may, in its discretion, also authorize banks located in any city to establish branches within other cities having a population of not less than fifty thousand inhabitants.

(c) This section shall not be construed to prohibit the merger of banks in the same or adjoining counties or of banks located within a distance of twenty-five miles of a parent bank and the operation by the merged company, of such banks, nor to prohibit the sale of any bank to, and the purchase thereof by, any other bank in the same or adjoining counties or within a distance of twenty-five miles and the operation of such banks by the purchasing bank, provided the approval

of the State Corporation Commission is first had, and provided, further that at the time of such merger or purchase, each of the banks involved shall have been in actual operation for a period of two years or more, except that in any case in which the State Corporation Commission is satisfied that the public interest demands, on account of emergency conditions, that a merger or sale be effected, it may enter an order to such effect permitting such merger or sale, notwithstanding that the banks involved or one or more of them, have not been in actual operation for two or more years. The term "adjoining counties", where more than two are involved, shall be construed to mean counties each of which shall adjoin the county in which the parent bank is located.

(d) This section, however, shall not apply to branch banks already established.

(e) No branch bank heretofore or hereafter established shall be operated or advertised under any other name than that of the identical name of the home bank, unless permission be first had and obtained from the State Corporation Commission, and unless such different name shall contain or have added thereto language clearly indicating that it is a branch bank and of which bank it is a branch.

Any bank or trust company violating the provisions of this section shall be liable to a fine of one thousand dollars, to be imposed and judgment entered therefor by the State Corporation Commission, and enforced by its process.

APPENDIX E

STATISTICAL DATA

TABLE E-I

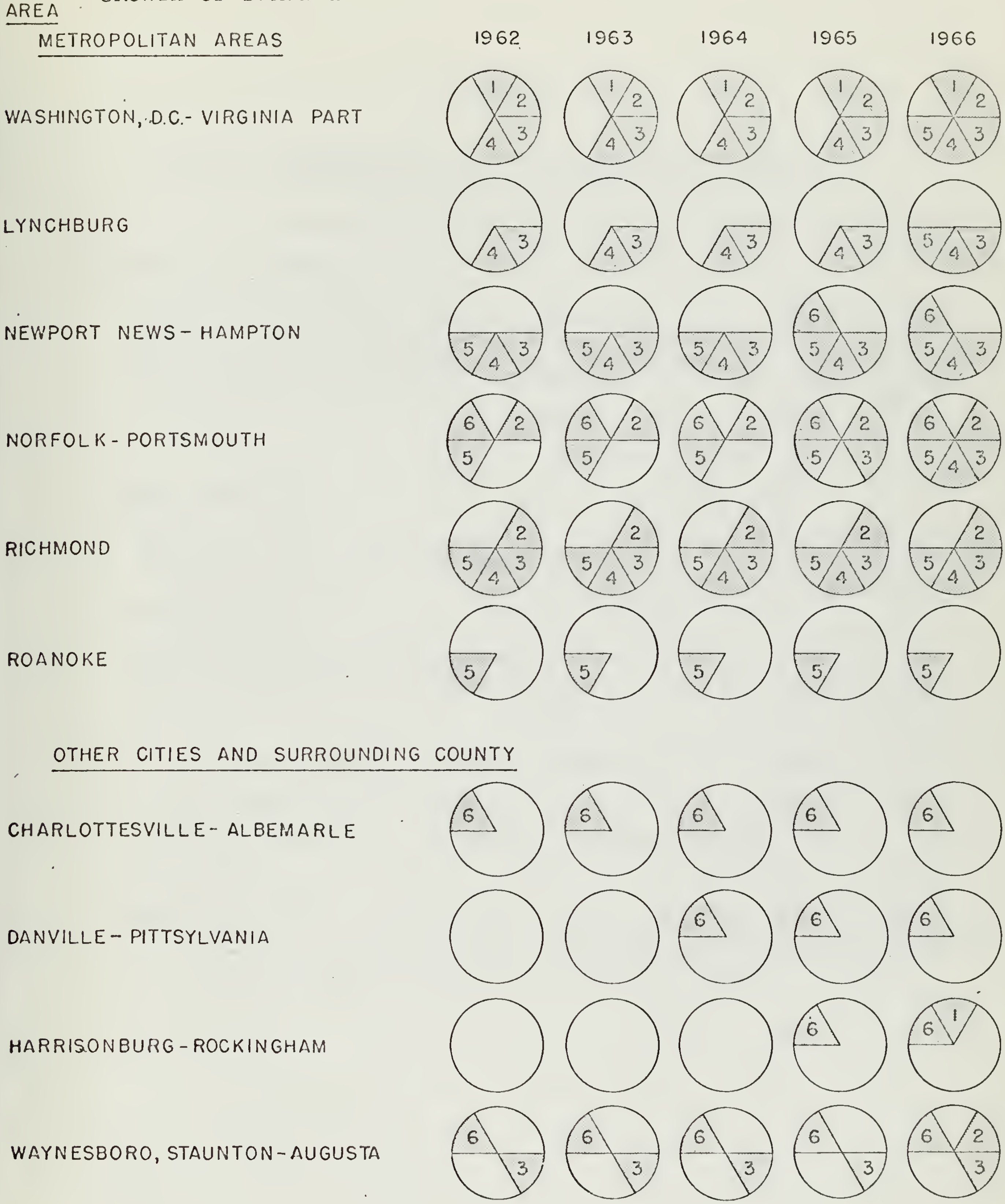
TWENTY LARGEST BANKS IN VIRGINIA DECEMBER 31, 1947

	BANK NAME	DEPOSITS
1.	First and Merchants National Bank, Richmond	$159,046,714
2.	State-Planters Bank of Commerce and Trust, Richmond	121,499,121
3.	National Bank and Commerce, Norfolk	115,975,034
4.	Central National Bank, Richmond	62,441,592
5.	First National Exchange, Roanoke	58,292,860
6.	The Bank of Virginia, Richmond	53,073,040
7.	Seaboard Citizens National Bank, Norfolk	52,225,103
8.	First National Bank, Newport News	29,461,578
9.	Bank of Commerce and Trust, Richmond	25,970,639
10.	Peoples National Bank, Charlottesville	24,635,496
11.	Colonial American National Bank, Roanoke	21,158,494
12.	First National Bank, Danville	19,454,966
13.	American National Bank, Portsmouth	19,396,447
14.	First National Bank, Lynchburg	17,926,398
15.	Southern Bank and Trust Company, Richmond	17,448,422
16.	Mountain Trust Bank, Roanoke	17,262,963
17.	American National Bank and Trust Company, Danville	15,353,839
18.	Arlington Trust Company, Inc., Arlington	15,266,900
19.	Southern Bank of Norfolk, Norfolk	14,202,529
20.	Lynchburg National Bank and Trust Company, Lynchburg	13,776,076
	TOTAL	$873,868,211
	STATE TOTAL	$1,490,435,000
	PERCENTAGE OF STATE TOTAL:	
	Largest Five	34.7
	Largest Ten	47.1
	Largest Twenty	58.6

NOTE: Data from unpublished statistics, "Virginia Banking Survey For Years of 1947, 1961-1966," Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia.

TABLE E-II

GROWTH OF STATEWIDE BANKING SYSTEMS IN VIRGINIA 1962-1966



1 - FINANCIAL GENERAL
2 - FIRST VIRGINIA
3 - FIRST AND MERCHANTS
4 - UNITED VIRGINIA BANKSHARES
5 - VIRGINIA COMMONWEALTH
6 - VIRGINIA NATIONAL

NOTE: Data from Bureau of Population and Economic Research, "Virginia Banking Survey For Years of 1947, 1961 through 1966", unpublished statistics (Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, 1966).

TABLE E-III

HOLDING COMPANIES AND THEIR SUBSIDIARIES OPERATING IN VIRGINIA AS OF DECEMBER 31, 1961

Financial General	
Alexandria National Bank, Alexandria	$ 33,935,229
Shenandoah Valley National Bank, Winchester	13,826,507
Arlington Trust Company, Inc., Arlington	47,018,161
Clarendon Trust Company, Arlington	25,251,056
TOTAL	$120,030,953
First Virginia	
National Bank of Manassas	$ 5,483,313
First National Bank of Purcellville, Purcellville	4,154,098
Old Dominion National Bank of Fairfax, Annandale	8,429,377
Old Dominion Bank, Arlington	46,785,749
Falls Church Bank, Falls Church	24,556,884
TOTAL	$ 89,409,421
TOTAL HOLDING COMPANY DEPOSITS	$209,439,374
TOTAL STATE DEPOSITS	$3,552,314,000
% HOLDING CO. DEPOSITS OF STATE DEPOSITS	5.9%

NOTE: Data from unpublished statistics, "Virginia Banking Survey For Years 1947, 1961-1966," Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia.

TABLE E-IV

HOLDING COMPANIES AND THEIR SUBSIDIARIES OPERATING
IN VIRGINIA AS OF DECEMBER 31, 1966

Financial General Corporation, Washington, D. C.	
Alexandria National Bank, Alexandria	$ 51,498,619
Arlington Trust Company, Inc., Arlington	76,658,323
Clarendon Trust Company, Arlington	48,836,380
Peoples Bank of Buena Vista, Inc., Buena Vista	2,731,933
Valley National Bank, Harrisonburg	12,523,177
Republic Bank & Trust Company, Herndon	1,280,580
The Peoples National Bank of Leesburg, Leesburg	13,761,492
The First National Bank of Lexington, Lexington	4,781,091
The Round Hill National Bank, Round Hill	5,926,481
The Shenandoah Valley National Bank of Winchester, Winchester	17,317,754
TOTAL	$235,315,830
The First Virginia Corporation, Arlington	
Mount Vernon National Bank and Trust Company of Fairfax County, Annandale	$ 65,398,057
Old Dominion Bank, Arlington	93,672,035
Falls Church Bank, Falls Church	32,824,383
The National Bank of Manassas, Manassas	10,619,767
Peoples' Bank, Mount Jackson	4,723,345
Southern Bank of Norfolk, Norfolk	41,606,142
First National Bank of Purcellville, Purcellville	6,195,856
Bank of New River Valley, Radford	6,427,414
First Valley National Bank, Rich Creek	4,689,608
Richmond National Bank, Richmond	16,265,590
Staunton Industrial Bank, Staunton	5,825,510
Massanutten Bank of Shenandoah Valley, National Association, Strasburg	13,246,757
TOTAL	$301,494,464
Virginia Commonwealth Bankshares, Inc., Richmond	
Washington Trust Bank, Bristol	$ 13,928,083
The Bank of Central Virginia, Lynchburg	2,409,468
Bank of Warwick, Newport News	26,214,252
The Peoples National Bank of Pulaski, Pulaski	7,764,888
The Bank of Virginia, Richmond	234,201,957
The Bank of Salem, Salem	15,668,494
The Bank of Prince William, Woodbridge	22,118,830
TOTAL	$322,305,972

(continued)

TABLE E-IV (continued)

United Virginia Bankshares Inc., Richmond	
First and Citizens National Bank, Alexandria	$114,341,983
Spotswood Bank, Harrisonburg	15,934,055
Rockbridge Bank & Trust Company, Lexington	9,819,685
First National Trust and Savings Bank of Lynchburg, Lynchburg	145,946,682
Citizens and Marine Bank, Newport News	54,549,559
Merchants and Farmers Bank of Franklin, Franklin	7,603,217
State-Planters Bank of Commerce and Trusts, Richmond	341,038,058
The Vienna Trust Company, Vienna	27,363,341
Peninsula Bank and Trust Company, Williamsburg	23,673,768
	$640,270,348
TOTAL HOLDING COMPANY DEPOSITS	$1,499,386,614
TOTAL STATE DEPOSITS	$5,325,334,500
PERCENTAGE HOLDING COMPANY DEPOSITS OF STATE DEPOSITS	28.1

NOTE: Data from 1966 Annual Report of the Bureau of Banking, State Corporation Commission, Commonwealth of Virginia; Bureau of Population and Economic Research, "Virginia Banking Survey For Years of 1947, 1961 through 1966," unpublished statistics (Charlottesville, Virginia: Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia, 1966.)

TABLE E-V

TEN LARGEST BANKING ORGANIZATIONS IN VIRGINIA DECEMBER 31, 1966

1.	United Virginia Bankshares, Inc., Richmond	$ 640,270,348
2.	Virginia National Bank, Norfolk	536,086,579
3.	First and Merchants National Bank, Richmond	535,156,910
4.	Virginia Commonwealth Bankshares, Inc., Richmond	322,305,972
5.	First Virginia Corporation, Arlington	301,494,464
6.	First National Exchange Bank, Roanoke	300,278,779
7.	Financial General Corporation, Washington, D. C.	235,315,830*
8.	Central National Bank, Richmond	168,170,865
9.	Lynchburg National Bank and Trust, Lynchburg	128,176,433
10.	Seaboard Citizens National Bank, Norfolk	110,506,405
	TOTAL	$3,277,762,585
	STATE TOTAL	$5,325,334,000
	PERCENTAGE OF STATE TOTAL	
	Largest Five	43.8
	Largest Ten	61.5

* Includes only Virginia Banks

NOTE: Data from unpublished statistics, "Virginia Banking Survey For Years of 1947, 1961-1966," Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia.

TABLE E-VI

GROWTH OF BANKS, BRANCHES, AND TOTAL FACILITIES
IN VIRGINIA, 1948-1966

Year	No. of Banks at Year End	No. of Branches at Year End	Net Yearly Change Banks	Net Yearly Change Branches	Total Facilities at Year End
1948	314	96	0	+8	410
1949	312	109	-2	+13	421
1950	313	114	+1	+5	427
1951	315	120	+2	+6	435
1952	315	128	0	+8	443
1953	316	144	+1	+16	410
1954	316	157	0	+13	473
1955	316	176	0	+19	492
1956	312	199	-4	+23	511
1957	313	217	+1	+18	530
1958	312	234	-3	+17	546
1959	309	255	-4	+21	564
1960	305	284	-3	+29	589
1961	302	320	-6	+36	622
1962	292	367	-10	+47	659
1963	280	430	-12	+63	710
1964	277	486	-3	+56	763
1965	262	558	-15	+72	823
1966	251	612	-11	+54	863

NOTE: Data from Board of Governors of the Federal Reserve System, "Number of Commercial Banks and Branches by States, FDIC, 1936-1963." "Supplement to Federal Reserve Board Number of Commercial Banks and Branches by States, 1936-1963, for the years 1964, 1965, and 1966."

TABLE E-VII

GROWTH OF BANKS, BRANCHES, AND TOTAL FACILITIES IN U. S., 1948-1966

Year	No. of Banks at Year End	No. of Branches at Year End	Net Yearly Change Banks	Net Yearly Change Branches	Total Facilities At Year End
1948	14,221	4,431	-13	+194	18,652
1949	14,205	4,665	-16	+234	18,870
1950	14,164	4,945	-41	+280	18,109
1951	14,132	5,264	-32	+319	19,396
1952	14,088	5,587	-44	+323	19,675
1953	14,024	5,957	-64	+370	19,981
1954	13,881	6,433	-143	+486	20,324
1955	13,756	7,062	-125	+619	20,818
1956	13,680	7,740	-76	+678	21,420
1957	13,607	8,372	-73	+632	22,079
1958	13,504	9,068	-67	+696	22,572
1959	13,486	9,790	-54	+722	23,276
1960	13,484	10,619	-2	+829	24,103
1961	13,444	11,499	-40	+880	24,943
1962	13,439	12,492	-5	+922	25,931
1963	13,582	13,652	+143	+1,161	26,234
1964	13,775	14,771	+193	+1,119	28,546
1965	13,818	15,918	+43	+1,147	29,736
1966	13,785	17,087	-33	+1,169	30,872

NOTE: Data from Board of Governors of the Federal Reserve System, "Number of Commercial Banks and Branches by States, FDIC, 1936-1963." "Supplement to Federal Reserve Board Number of Commercial Banks and Branches by States, 1936-1963, for the years 1964, 1965, and 1966."

TABLE E-VIII

TWENTY LARGEST BANKS IN VIRGINIA DECEMBER 31, 1966

	Bank Name	Deposits
1.	Virginia National Bank, Norfolk	$ 536,086,579
2.	First and Merchants National Bank, Richmond	535,156,910
3.	State-Planters Bank of Commerce and Trust, Richmond	341,038,058
4.	First National Exchange, Roanoke	300,278,779
5.	The Bank of Virginia, Richmond	234,201,957
6.	Central National Bank, Richmond	168,170,865
7.	Lynchburg National Bank and Trust Company, Lynchburg	128,176,433
8.	First and Citizens National Bank, Alexandria	114,341,983
9.	Seaboard Citizens National Bank, Norfolk	110,506,405
10.	Old Dominion Bank, Arlington	93,672,035
11.	Arlington Trust Company, Inc., Arlington	76,658,323
12.	Mount Vernon National Bank and Trust Company, Annandale	65,398,057
13.	Southern Bank and Trust Company, Richmond	64,821,061
14.	Colonial American National Bank, Roanoke	62,843,905
15.	National Bank and Trust Company, Charlottesville	62,312,984
16.	Citizens and Marine Bank, Newport News	54,549,559
17.	Alexandria National Bank, Alexandria	51,498,619
18.	Clarendon Trust Company, Arlington	48,836,380
19.	Mountain Trust Bank, Roanoke	46,836,756
20.	First National Trust and Savings Bank, Lynchburg	45,946,682
	TOTAL	$3,141,322,330
	STATE TOTAL	$5,325,334,000
	PERCENTAGE OF STATE TOTAL	
	Largest Five	36.0
	Largest Ten	47.6
	Largest Twenty	59.0

NOTE: Data from unpublished statistics, "Virginia Banking Survey For Years of 1947, 1961-1966," Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia.

TABLE E-IX

TWENTY LARGEST BANKS IN VIRGINIA DECEMBER 31, 1961

	Bank Name	Deposits
1.	First and Merchants National Bank, Richmond	$275,914,000
2.	State-Planters Bank of Commerce and Trust, Richmond	237,626,235
3.	National Bank and Commerce, Norfolk	197,466,074
4.	The Bank of Virginia, Richmond	150,974,217
5.	Central National Bank, Richmond	134,856,768
6.	First National Exchange, Roanoke	126,436,466
7.	Peoples National Bank, Charlottesville	94,981,413
8.	Seaboard Citizens National Bank, Norfolk	71,913,520
9.	First and Citizens National Bank, Alexandria	62,869,455
10.	Arlington Trust Company, Inc., Arlington	47,018,161
11.	Old Dominion Bank, Arlington	46,785,749
12.	First National Bank, Newport News	44,777,160
13.	Colonial American National Bank, Roanoke	42,080,567
14.	Southern Bank and Trust Company, Richmond	41,208,434
15.	Lynchburg National Bank and Trust Company, Lynchburg	38,828,098
16.	First National Bank, Lynchburg	34,376,097
17.	Mountain Trust Bank, Roanoke	34,213,529
18.	Alexandria National Bank	33,935,229
19.	National Bank and Trust, Charlottesville	33,017,673
20.	First National Bank, Danville	29,600,734
	TOTAL	$1,778,879,579
	STATE TOTAL	$3,552,314,000
	PERCENTAGE OF STATE TOTAL:	
	Largest Five	25.1
	Largest Ten	39.4
	Largest Twenty	50.1

NOTE: Data from unpublished statistics, "Virginia Banking Survey For Years of 1947, 1961-1966," Bureau of Population and Economic Research, Graduate School of Business Administration, University of Virginia.

APPENDIX F

BRANCHING PROVISIONS OF THE 1948 LEGISLATION

(EXCERPTS FROM THE CODE OF VIRGINIA 1950)

6-26. When branch banks may be authorized; branches already established. --No bank or trust company heretofore or hereafter incorporated under the laws of this state shall be authorized to engage in business in more than one place, except that the State Corporation Commission, when satisfied that public convenience and necessity will thereby be served, may authorize banks having paid-up and unimpaired capital and surplus of fifty thousand dollars or over to establish branches within the limits of the city, town or village in which the parent bank is located.

This section shall not apply to branch banks established prior to June twenty-ninth, nineteen hundred forty-eight, nor to branches theretofore authorized by the Commission but not yet opened.

6-27. Operation of branches after merger or purchase. --The provisions of the preceding section shall not be construed to prohibit the merger of banks in the same or adjoining counties or of banks located within a distance of twenty-five miles of a parent bank and the operation by the merged company of such banks, nor to prohibit the sale of any bank to, and the purchase thereof by, any other bank in the same

or adjoining counties or within a distance of twenty-five miles and the operation of such banks by the purchasing bank provided that the State Corporation Commission shall be of the opinion and shall first determine that public convenience and necessity will be served by such operation, and provided further that, at the time of such merger or purchase, each of the banks involved shall have been in actual operation for a period of five years or more. But in any case in which the Commission is satisfied that the public interest demands, on account of emergency conditions, that a merger or sale be effected, it may enter an order to such effect permitting such merger or sale, notwithstanding that the banks involved, or one or more of them, have not been in actual operation for five or more years. The term "adjoining counties", where more than two are involved, shall be construed to mean counties each of which shall adjoin the county in which the parent bank is located.

APPENDIX G

THE VIRGINIA METROPOLITAN PLAN

to meet the growing industrial and banking needs of the Commonwealth while safeguarding the traditional independence and service of Virginia's county banks.

HOW ONE SMALL OVERSIGHT in the 1948 Statutes IS CREATING TWO BIG DANGERS

Excellent as they are, the Virginia Banking Statutes of 1948 do not allow for the reality of growing metropolitan areas. As a result, they hamper and often block the urgently needed development of true metropolitan and intermetropolitan banking.

Metropolitan areas are defined here as cities of not less than 15,000 population and the area within five miles of the corporate limits of such cities.

This one, easily remedied oversight is creating two important threats to the state's economy. It puts a brake on industrial growth. It opens the door to out-of-state competition by banks with larger lending limits than even the largest Virginia banks can offer under present legislation.

A NEEDED ADDITION ... THE METROPOLITAN CONCEPT

Especially during the past dozen years, close-knit metropolitan areas have developed in Virginia. They may be

in the 30,000 population bracket, like Winchester. Or they may be a complex of larger cities, like the ports around Hampton Roads, increasingly woven together by a web of bridges and tunnels. Or, like Richmond, Hopewell, Colonial Heights and Petersburg, strung together like adjacent beads on the busy thread of the Turnpike.

The characteristic of these metropolitan areas is that, regardless of the political "city limits" that criss-cross and divide them, each area forms an increasingly integrated economic entity. In the past decade, almost 89% of Virginia's population growth has been concentrated in these metropolitan areas ... a total of 573,000 new residents. Similarly, 82% of Virginia businesses with a net worth of $1,000,000 or more are concentrated in these areas. The two create a mounting pressure for true metropolitan area banking ... with larger loan capacity.

HOW DO VIRGINIA'S LARGEST BANKS COMPARE WITH THOSE ELSEWHERE?

Twenty-one states with smaller populations have one or more banks larger than any in Virginia. Only four of the twelve Federal Reserve Districts have larger banking resources than the Fifth District. Yet every other Federal Reserve City has one or more banks larger than Richmond's largest. With the exception of West Virginia, every state bordering Virginia,

as well as the District of Columbia, has at least one bank larger than the largest in Virginia.

SMALL CREDIT LINES, AN OBSTACLE TO NEW INDUSTRY

Large industries need large credit lines. The biggest bank in Virginia can offer only $1,550,000. Or consider this: Richmond has four of the six largest banks in the state. Yet all four combined can offer an industry no more than $4,950,000. By contrast, in any of 15 North Carolina cities, an industry can obtain $5,000,000 from a single bank.

There is considerable evidence that such inadequate banking service hinders industrial development in Virginia. While the Old Dominion has done a "pretty good" job in attracting new industries in some areas, and achieved a rate of industrial growth somewhat above the national average, it has fallen behind its neighbors. In today's competition for industry, "pretty good" just isn't good enough. Between 1948 and 1958, Virginia's dollar growth in per capita value added by manufacture was 25% less than that of North Carolina. The latter state has nearly 50% more manufacturing concerns per capita, and nearly 60% more employees engaged in industry per capita. And in both categories, Virginia fell below at least four other states in its area.

THE OPEN DOOR TO OUTSIDE BANKING COMPETITION

Equally serious from the standpoint of Virginia's financial community, the comparative smallness of the state's largest banks invites out-of-state banking. Scores of Virginia's new or expanding industries now go outside its borders to get the credit lines they need. In other words, when the state has attracted new or bigger industries, much of the benefit to the banking community is channeled away by the limitations of Virginia's metropolitan banks.

CAN VIRGINIA MEET THE CHALLENGE?

Virginia has a strong tradition of doing business locally. Its non-metropolitan banks provide excellent service for their counties and communities. They are protected by the Banking Statutes of 1948.

At the same time, the development of growing metropolitan areas and industry's need for larger credit lines are building up relentless pressure for bigger metropolitan banks. Can Virginia make possible such banks? This is precisely the purpose of the Virginia Metropolitan Plan.

HOW TO FIT THE METROPOLITAN AREA CONCEPT INTO PRESENT LAWS

The 1948 Statutes permit the merger of banks five or more years old <u>only</u> if their head offices are within 25 miles

of each other, or lie within the same city limits, or within the same or adjoining counties.

The Virginia Plan would amend this to permit merger between banks with head offices in any metropolitan area.

The 1948 Statutes restrict a bank's branches to the same city or the same county in which its head office is located.

The Virginia Plan would amend this to permit a bank with its head office in a metropolitan area to establish and operate branches in any other metropolitan area in which it had one or more branches. In other words, when banks in two metropolitan areas merged, they would not be penalized by having a main office in only one. They would still be able to establish branches in both metropolitan areas.

To meet the realities of present day suburbanism, the Virginia Plan would also amend the present laws to permit a city bank to have branches within five miles of its city limits ... and county banks to have branches in adjacent cities.

HOW THE VIRGINIA METROPOLITAN PLAN BENEFITS THE STATE AND ALL ITS BANKS

Under the Virginia Plan, metropolitan banks would be able to merge and achieve the larger credit limits essential to serve and attract modern industry. At the same time, they

would be able to provide service to their city customers with homes or businesses in the nearby suburbs.

County banks adjacent to cities could retain the full banking business of county residents with city jobs or businesses.

Non-metropolitan and county banks would keep the protection afforded by the 1948 Bank Statutes. They would benefit from the greater impetus to Virginia industry and from the stronger correspondent relationships provided by larger metropolitan area banks.

The Virginia Metropolitan Plan offers a way by which the Old Dominion can go forward financially and industrially in its own traditions.

TODAY'S LAWS AND THE VIRGINIA METROPOLITAN PLAN

1948 STATUTES

MERGERS -- Provided both banks have been in existence five years, mergers are permitted

--if the banks' main offices are within 25 miles of each other, or

--if the banks' main offices are in the same or adjoining counties or in the same city.

BRANCHES -- Can be established if they are within the county or city of the bank's main office.

THE VIRGINIA METROPOLITAN PLAN

MERGERS -- Retain provisions of the 1948 Statutes and add permission to merge

--if each bank's main office is located in any metropolitan area.

BRANCHES -- Retain provisions of the 1948 Statutes and add that branches can be established

--by a metropolitan area bank in any other metropolitan area provided such bank already has a branch in the area.

--by a city bank within five miles of its city limits.

--by a county bank within any city adjacent to the county of its main office.

APPENDIX H

BRANCHING PROVISIONS OF THE 1962 LEGISLATION (EXCERPTS FROM THE CODE OF VIRGINIA 1950 AND THE 1964 CUMULATIVE SUPPLEMENT)

6-26. When branch banks may be authorized; branches already established. --No bank or trust company heretofore or hereafter incorporated under the laws of this State shall be authorized to engage in business in more than one place, except that the State Corporation Commission, when satisfied that public convenience and necessity will thereby be served, may authorize banks having paid-up and unimpaired capital and surplus of fifty thousand dollars or over to establish branches within the limits of the city, town or county in which the parent bank is located or to establish branches elsewhere by merger with banks located in any other county, city or town.

This section shall not be construed to prohibit the operation of existing branch banks heretofore established.

The term "parent bank" shall be construed to mean the bank or banking office at which the principal functions of the bank are conducted. The location of a parent bank or of a branch bank may be moved if the State Corporation Commission determines that public convenience and necessity will be served by such move; but the location of a parent bank or of a branch bank may not be moved beyond the limits of the city, town or county in which it is located except through a merger with another bank.

6-27. Operation of branches after merger or purchase. --The preceding section (6-26) shall be construed to allow the merger of banks and the operation by the merged company of such banks, and to allow the sale of any bank to, and the purchase thereof through merger by, any other bank and the operation of such banks by the merged bank, provided that the State Corporation Commission shall be of the opinion and shall first determine that public convenience and necessity will be served by such operation, and provided further that, at the time of such merger the banks involved shall have been in actual operation for a period of five years or more. But in any case in which the Commission is satisfied that the public interest demands, on account of emergency conditions, that a merger be effected, it may enter an order to such effect permitting such merger notwithstanding that the banks involved, or one or more of them, have not been in actual operation for five or more years.

6-27.1. When public necessity need not be proved on application for certificate of authority under 6-31. --(a) When an application is made to the State Corporation Commission by a bank pursuant to 6-31 for a certificate of authority to commence business in a political subdivision it shall not be necessary to prove the requirements of the paragraph numbered (4) of 6-31 or, under 6-31 to prove the public necessity for banking or additional banking facilities in the community where

the bank is proposed to be located when all of the banks located in such political subdivision are owned or controlled (1) by "bank holding companies" or (2) when all of the banks located in that political subdivision are owned or controlled by "merged banks" or (3) when all of the banks located in such political subdivision are owned or controlled by "bank holding companies" and "merged banks".

(b) "Merged bank" means any bank which has acquired another bank under the provisions of 6-26 and 6-27 which has its principal office in one political subdivision and a branch in another political subdivision.

(c) "Bank holding company" means any company (1) which directly or indirectly owns, controls or holds with power to vote, twenty-five per centum or more of the voting shares of each of two or more banks or of a company which is or becomes a bank holding company by virtue of this section, or (2) which controls in any manner the election of a majority of the directors of each of two or more banks, or (3) for the benefit of whose shareholders or members twenty-five per centum or more of the voting shares of each of two or more banks or a banking holding company is held by trustees; and for the purpose of this section, any successor to any such company shall be deemed to be a bank holding company from the date as of which such successor co-company becomes a bank holding company. Notwithstanding the foregoing, (A) no bank shall be a

bank holding company by virtue of its ownership or control of shares in a fiduciary capacity, except where such shares are held for the benefit of the shareholders of such banks, (B) no company shall be a bank holding company by virtue of its ownership or control of its shares acquired by it in connection with its underwriting of securities and which are held only for such period of time as will permit the sale thereof upon a reasonable basis, (C) no company formed for the sole purpose of participating in a proxy solicitation shall be a bank holding company by virtue of its control of voting rights or shares acquired in the course of such solicitation, and (D) no company shall be a bank holding company if at least eighty per centum of its total assets are composed of holdings in the field of agriculture.

6-27.2 Establishment of branch banks in contiguous counties or cities. --Notwithstanding the limitations of 6-26 and 6-27, the State Corporation Commission may, when satisfied that public convenience and necessity will thereby be served, authorize the establishment of branch banks in cities contiguous to the county or city in which the parent bank is located, and the establishment of branch banks in counties contiguous to the city in which the parent bank is located. Establishment of such branches may be by merger, consolidation, purchase of assets or creation of a new branch; but if the parent bank is located in a city such branches in the contiguous county may not be established more than five miles outside the city limits.